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The Region and Global Economic Governance

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The Logo

To better represent the underlying ideas that gave birth to CSIS in 1971, the Centre uses as of 1989 the logo that figures on the front cover of this journal. The original, in bronze, was designed by Indonesia's renowned sculptor G. Sidharta and comprises a disc with an engraving of the globe, which serves as a backdrop to a youth with an open book on a cloth draped across his lap, his left hand pointing into the book, and his right raised upwards. All these elements combine to project the Centre's nature as an institution, where people think, learn and share their knowledge. Mankind is their concern and the world their horizon. The undressed torso symbolises open-mindedness and the absence of prejudice in the attitude of the scholars who work with the Centre, just as it is with scholars everywhere. The inscription reads "Nalar Ajar Terusan Budi", in the Javanese language, conveys the Centre's belief that "to think and to share knowledge are the natural consequences of an enlightened mind." It is a surya sengkala that is chandra sengkala - a Javanese traditional way to symbolise a commemorable year in the lunar calendar, adapted to the solar calendar system. It uses words that express the perceived meaning of the commemorated year while marking the year at the same time, with each word having a numerical value. Thus, the inscription, in reverse order, represents the year CSIS was established: 1971.

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The Region and Global Economic Governance

Indonesia's Trade Policy Challenges

Indonesia is a largely open economy, but this openness on occasion remains precarious. There are political economy, rent-seeking forces opposed to the current openness, and much of the country's influential public opinion is skeptical of the merits of an open economy and deeper global commercial integration. There is no institutionalised support for openness in its bureaucracy and polity. A key question is why the country has remained open, particularly since the 1997-98 crisis.

Privatisation Policy and Its Implications

Privatisation program is a policy that has to be executed by the Government who wants to restructure its economy. Through privatisation (especially using Initial Public Offering or IPO), economic growth can be created. This paper seeks to investigate the implications of privatisation policy towards the performance of State-Owned Companies in Indonesia, using the Telkom case as a case study.

Review of Developments

A DISCUSSION ON THE REGION AND GLOBAL ECONOMIC GOVERNANCE

Jusuf Wanandi, Hadi Soesastro and Soogil Young

INTRODUCTION

The existing multilateral system has strived to respond to the need for an international rules-based framework since the 1940s. Yet, the challenges of globalisation today cannot effectively be handled by a system that was designed mainly for the world of over half a century ago. The existing system has no formal institutional mechanism for a range of common problems, which has made it unable to ensure that voices representing all relevant domains and regions are taken into account. Taking into account the recent G20 meeting, the economic crisis, and the growing significance of regionalism, the following three articles aim to contribute to the discussion of how to fill the existing gaps in global economic governance.

JUSUF WANANDI: *THE REGION AND GLOBAL ECONOMIC GOVERNANCE*

Two questions of importance have to be raised in relation to regional developments in East Asia. To begin with, what is the impact of the economic crisis on regionalism in the Asia Pacific and East Asia, and what can regionalism do to solve the crisis?

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This is a global crisis and therefore the solution also has to be global, and G20 is the appropriate forum for this. But regional institutions are important as building blocks that give G20 its legitimacy because they enable more countries to be involved, indirectly participate and provide feedback as well as disseminate the G20 decisions to the respective regions and their members.

The problem now is that existing regional institutions in Asia Pacific and East Asia are not yet adequately equipped to deal with the crisis and to give support to the G20.

The ASEAN Plus Three (APT) process should be the best equipped forum because it has come about in response to the region's efforts to create self-help mechanisms to deal with a financial crisis. However, this process has been slow. Already in 2007, the APT finance ministers agreed on strengthening the Chiang Mai Agreement (CMI) by transforming the bilateral swap arrangements into a multilateralised CMI. In Beijing in October 2008, on the sidelines of the ASEM, the leaders endorsed that idea, but after 6 months of efforts this new fund of US$120 billion is still only on paper. Even if it were to become operational, this fund alone would not be sufficient to help overcome the impact of the current global crisis in the region. What the region needs is to have sufficient funding that enables regional countries to undertake effective and coordinated counter-cyclical measures or stimulus packages.

It was unfortunate that APT leaders were again unable to get together in the second week of April 2009 to step up and coordinate their efforts due to Thailand's internal political problems. But that was not the only problem. Even during the process to strengthen the CMI (its multilateralisation and increasing its size) it was not easy to get the Finance Ministers to come together to forge an agreement on its implementation.

That shows that East Asia is not really ready to move into practical cooperation when needed. And while it is fashionable to talk about the shift of economic power towards East Asia this region is not ready to take over any leadership soon. First, because there is not enough trust among the big powers in the region. Second, it does not have the institutional structure and rules to do so. Third, the region does not have enough intellectual capacity yet to lead, even on regional issues, and much less on global issues and cooperation.

East Asia might need two to three decades more to prepare itself for that kind of intellectual leadership to lead in its own region and the world together with other big powers such as the US and the European Union (EU).

The new global governance will be based on existing foundation of rules and institutions, but adjusted to new challenges, with the input of some of the leading countries (e.g., G20), including from East Asia.

APEC was also found wanting in the 1997-1998 Asian financial crisis. Since then APEC had a hard time to re-define her objectives to be relevant to the region. Reactions to September 11 made it possible for President Bush to divert APEC attentions to other issues than the economy such as anti-terrorism and human security.

Since then APEC was looking for ways and means to recover from the malaise. First is for East Asia to be an active caucus in and strengthen APEC, which is meant to ensure a US engagement in the East Asia region. Second, the Summit should be led informally by a group of the G20 members in the region, that also could deal with strategic issues (political and security). This group could come together before an APEC Summit to analyze trends in the region and propose the direction for APEC's development. The group will consists of US, China, Japan, Russia, Korea, Indonesia, Australia, Canada and Mexico. India, another G20 member, should be invited to become a member of APEC.

As this group is informal in nature, it presumably will not create too much reaction from the others, and it is based on an existing institution. This would prevent the region from starting all over again in its search for a new regional institution.

Since East Asia is an important part in APEC, the US does not need to be directly involved in APT or the East Asia Summit (EAS), although the US is seriously considering signing on to the Treaty of Amity and Cooperation (TAC).

In so doing we are going to strengthen APEC, which is what everybody is wishing, as it is the only regional institution to cover both sides of the Pacific. It has the US inside, and it has trans-Pacific vehicles to really work on financial and economic crises in the medium term. East Asia can do more things with the US through APEC. This

is the right time as the Obama administration is positively shaping up US policies towards East Asia.

Having the members of the G20 from the Asia Pacific to come together before the APEC Summit could fill a lacuna in the architecture of East Asia (EA), namely to involve the US, and at the same time to be able to deal with strategic (political and hard security) issues.

APEC has now a real chance to be renovated because until now we do not have a trans-Pacific group that deals with the financial issues to respond to future crises. Trans-Atlantic Cooperation does exist, and a strong EU is there. East Asia has made some first steps in the APT's CMI, but a trans-Pacific arrangement could be more effective in the future to overcome a crisis.

However, such cooperation is not only meant to overcome the crisis, but more importantly to respond to the medium and long term challenges that the crisis has brought about, such as necessary structural changes, social safety net, and enhancing the national resilience of each member country.

APEC is in the process of restructuring itself by having a more professional and enlarged secretariat. Furthermore, the next three like-minded governments of Singapore, Japan and USA will lead APEC in the next 3 years, and Indonesia will chair in 2013 after Russia. As is the case in such regional institutions, the convener of APEC will play a leading role in the organisation and its activities. PECC can support these efforts with studies, research and networking. It can contribute to the strengthened Asia Pacific region, and this year PECC will organise a big conference in Singapore to identify the issues that the region is likely to have to deal with in the next three to five years.

The other question regards ASEAN's development, which also is going through some critical period. There is no doubt that ASEAN has contributed to South East Asian peace and economic development over the last 40 years or so as it was meant to be when it was created in 1967. But it is still questionable whether deeper integration could be possible and whether ASEAN could overcome her future challenges, not the least to the rise of China and India.

Deeper integration will depend on the result of efforts to create an economic community in 2015, whose implementation is still a real challenge. Political development will depend on how the regional

Human Rights (HR) body will look like: empowered or not to examine each others' HR developments and abuses. Security cooperation will depend on trust to each other and getting into the habit of cooperation, such as happened in the Aceh conflict in Indonesia that has been overcome with the assistance of ASEAN and the EU. But other ASEAN countries (Myanmar, Cambodia and even Thailand) are still very sensitive about such cooperation.

In all of these developments ASEAN often could not get its act together. That is clearly demonstrated in the newly introduced Charter that in affect organises an ASEAN for the past and not for the future. When in 2003 the idea of an ASEAN Community was accepted by all its members, it was understood that gradually ASEAN will be based on the same values such as political freedoms, rule of law, human rights and democracy. This should be a step-by-step approach but there should be possibilities for every member to assist, support and push each other in the implementation of the ideas and principles and to gradually open the political space and accept pluralism.

There is a concern that the Charter, in fact, will hamper those developments. The continued consensual decision making process hampers real changes; to entrust the Heads with the task of becoming the final arbiter of non-compliance will not work; the Secretariat has been given more authority but not enough budget; and nowhere are the people having a role or are being listened to. This also means that ASEAN cannot be at the driver's seat for East Asian regional institution building.

As an example is the way ASEAN was unable to do much to deal with the financial crisis. It was only at the end of February 2009 that the group talked about the crisis. The group could have supported the G20 members from East Asia in their participation in the London Summit. But that did not happen. The only decision was to strengthen the CMI through its multilateralisation. But the meeting to finalise it was delayed and aborted.

Another reason for ASEAN's weakness is the political instabilities in several of ASEAN's core members such as Thailand and Malaysia. Indonesia has developed well politically but it has no strong leader like Soeharto was to take the lead in ASEAN.

That is why for the time being, we could not expect that ASEAN could have a leadership role in regional institution building of East Asia and the Asia Pacific. She could not even perform due to a split among the members about ASEAN's future direction, namely on the deepening of regional integration.

The idea of an ASEAN Community to be established will not become a reality soon. At most ASEAN will remain as a diplomatic community for some time to come. Unless economic integration in 2015 is achieved, it will not be realistic to expect that ASEAN can take real steps to expanding its integration into the other pillars: political-security and social-cultural communities.

HADI SOESASTRO: *EAST ASIA, G20 AND GLOBAL ECONOMIC GOVERNANCE*

East Asian members of the G20 must participate strategically in this emerging global forum. They need to make sure that the G20 can produce policies and actions that will help bring the global economy out of the current crisis as soon as possible. Existing international institutions have been helpless in dealing with the issues the world now confronts and are in dire need of major reforms. There is now no better forum than G20. Essentially, it will act as a 'steering committee for the world economy', as Barry Eichengreen aptly said of the G20,[1] and this forum should now replace the G7 or G8 for good.

Yet the G20 is still very fragile. In part, this is due to its ad hoc nature. But it also suffers from problems of legitimacy in respect of how its membership is being determined. The problem has deepened with the inclusion of a few additional participants at the London Summit: why they and not others? The European members of the G20 are facing the greatest challenge from fellow Europeans on this issue although the EU already has a seat at the table.

East Asian members of the G20 will need to adopt a pro-active role to voice the concerns of, and to propose ideas, coming from the region. They already missed a good opportunity to do so when East Asian leaders met at the sidelines of the Asia Europe Meeting (ASEM) in Beijing about three weeks before the first G20 Summit in

[1] "The G20 and The Crisis," 2 March 2009; http://www.voxeu.org/index.php?q=node/3160.

Washington, D.C. Their preoccupation has been narrowly focused on the establishment of a regional emergency fund, based on the bilateral swap arrangements known as the Chiang Mai Initiative (CMI). This idea has been aired for some time before there was any sign of the current crisis, and efforts were stepped up after October 2008, but the fund will become operational only in April or May 2009.

This single focus from East Asia is far from adequate. Peter Drysdale suggests that East Asia might be performing in the 'wrong play'.[2] The key issues for East Asian members of the G20 are how measures for global recovery can be crafted collectively, what role the region can play to ensure a sustained and effective recovery, and how can the G20 be mobilised to re-shape global economic governance.

The crisis has created an opportunity for new players to bring their plight, interests and aspirations to bear towards more inclusive global efforts to resolve it. Dani Rodrik suggested that developing countries should seize this opportunity.[3] This will be important to a sustained recovery, but it is not clear how best developing countries can undertake the task. Should big developing countries like China, India, and Brazil represent the developing world?

Regional or sub-regional arrangements provide an alternative as they can be used to facilitate stronger voice and sense of ownership among smaller countries. Regional arrangements also include a mix of developed, emerging market, and less developing countries. The new global economic governance structure will need to be based on representative institutions.

There are demands to reform existing institutions to reflect the changing economic weight of emerging economies in the global economy. There is also the idea that these reformed institutions (the IMF and the World Bank) should be supervised by an over-arching and inclusive global institution, such as the United Nations global economic and social council as proposed by Germany's Chancellor Angela Merkel. But such a global organisation is likely to become rather unwieldy. The better alternative would be to have networks of

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[2] "East Asia and the global financial crisis," 25 December 2008; http://www.eastasiaforum.org/2008/12/25/east-asia-strategic-interests-in-fixing-the-global-financial-crisis/

[3] "Let developing nations rule," 28 January 2009; http://www.voxeu.org/index.php?q=node/2885

regional arrangements play into the global fora. East Asia's emergency fund, namely the multilateralised CMI, for instance, would be more meaningful if it also constituted a part of a network of monetary funds.

East Asia needs to be better coordinated if it is to develop a coherent regional agenda to contribute to resolving the global crisis. Meetings of East Asian leaders (ASEAN + 3 and the East Asia Summit) were scheduled to take place in April 2009 after the London Summit, but unfortunately it did not take place because of the political crisis in Thailand. In any case, East Asian Leaders should direct their finance ministers to have regular 'strategy meetings' to strengthen East Asia's engagement in formulating G20 policies and actions towards the recovery of the global economy and in shaping global economic governance.

In early March 2009 finance ministers and central bank governors from 19 Latin American countries convened a meeting in Portugal to demand a bigger say in global economic governance. Earlier, Russia also took the initiative in bringing together governments from the Commonwealth of Independent States (CIS) to present the group's interests in the G20. Such initiatives can only strengthen the G20 by increasing its legitimacy.

East Asia's strategic participation in the G20 is aimed not only at securing its role in global economic governance but also at increasing its effectiveness in projecting the region's strategic efforts towards global economic recovery.

East Asian countries overcame one major financial crisis a decade ago and undertook a raft of measures to reform and strengthen their financial sector with a good deal of success. Moreover, they have not taken measures that backtrack on their commitment to promote regional financial and economic integration. Presenting these ambitions through the G20 can also help sharpen the focus in the region in undertaking regional infrastructure development projects that could help stimulate the regional economy and recycle the region's huge reserves as well as promote structural adjustments to redress the global financial imbalance.

The region can also more effectively exert leadership on the trade front to keep global markets open, one of East Asia's top priorities

in the G20. The others are: ensuring adequate financial flows for development; and purposeful coordination of their economic stimulus packages.

SOOGIL YOUNG: *THE CASE FOR AN EAST ASIAN CAUCUS*

In the future, the Asian newly industrialising economies apparently would find themselves having no choice but to continue to pursue trade-led growth for development as well as open-door policies for their domestic financial and capital markets. But they are afraid that there is no assurance of the sustainability and stability of their economic growth unless the international financial architecture is reformed to remedy its revealed weaknesses and the disciplines of the multilateral trading system are strengthened.

China and the other Asian countries may seem to have been affected less severely by the global financial crisis than the newly industrialising economies for now but, as they see it, the damage being done to their real economies is large and serious. More significantly, Asia's confidence in the global economic architecture, and by the same token, in its outward-oriented development strategies, has been shaken profoundly.

The crisis shows that Asian economies face bleak prospects for continuing economic growth and development under existing global economic arrangements. If this is to change their economies, they need to be actively engaged in the reform of the architecture.

There is a *déjà vu* in this call. The Asian countries argued for a new international financial architecture in the wake of the regional financial crisis of 1997-1998. Under the auspices of the G7, a number of international financial reforms were implemented but these reforms, promoted by the finance ministers from seven industrialised nations, have not gone far in addressing the fundamental concerns of the developing countries.

The G20 was created in 1999, consisting of the finance ministers and central bankers from the G7 countries plus Australia and 11 large emerging market economies, such as Brazil, Russia, India and China (BRIC), as well as Korea, Indonesia, Mexico, Saudi Arabia, South Africa, and Turkey, in order to provide those emerging economies with an opportunity to participate in the discussion of matters pertaining

to the international financial system. It is also attended by the rotating chair country of the EU. The G20 has not to this point been very effective in injecting the concerns of emerging economies into the discussion of the reform of global financial architecture. The emerging economy participants in the process have failed in articulating and pressing their concerns.

East Asian countries, especially ASEAN+3, have focused on the promotion of financial and monetary cooperation at the regional level in order to supplement the global financial architecture. These regional efforts have made progress under two headings, the Chiang Mai Initiative (CMI) and the Asia Bond Market Initiative (ABMI). The current crisis underlines the need for Asian economies to accelerate that progress, especially that of the CMI, toward the creation of the Asian Monetary Fund which would augment the IMF. The efforts under ABMI should be accelerated toward the goal of creating integrated regional capital markets in order to help make regional savings more readily available to regional borrowers at lower cost.

Whatever efforts are made to create a new Asian regional financial architecture, they cannot supplant the need for reform and strengthening of the international financial system. The 11 non-advanced member countries of the G20 need to get serious about this imperative, and to provide substantive, creative and constructive inputs into the process that has been set in train by the activation of the G20 this time round, with the addition of the Summit process, occasioned by the global financial crisis. They need to assert themselves as major players as a new system of global economic governance unfolds.

Of the 11 non-advanced member countries, the 3 Asian countries, namely, Korea, China, and Indonesia, plus ASEAN as a regional institution to be represented within the G20 by its rotating chair government (Thailand, for now), can form a cohesive group for action and cooperate with one another in pursuit of fundamental reform of the international financial architecture, supportive of their common outward-oriented development strategy.

This 'East Asian Caucus' should provide leadership for all the emerging economies participating in the G20 process in steering the reform of the international financial architecture in ways which would best serve the developmental interests of emerging market economies.

This caucus should exercise leadership by forming a coalition of the like-minded on the reform, and by extending this coalition to Japan, Australia and India, which together are other major members of the East Asia Summit group, in the form of a possibly looser Asia-Pacific Coalition.

A window of opportunity is open for the East Asian Caucus and the Asia-Pacific Coalition on G20 to pursue this role. Korea is scheduled to chair the G20 process in 2010 and, for this reason, is currently among the triad countries—along with Brazil and the United Kingdom—which will be steering the G20 process during this year. The G20 process has been assured of a leading role in global economic governance reform by the launching of the G20 Summit. Participation by the heads of state from the non-advanced countries, and especially, from the East Asian Caucus and the broader Asia-Pacific Coalition, can critically strengthen the voice and influence of East Asian countries. These countries should seize this opportunity, and especially during 2009-2010, the Korean government should play a leading role in mobilising the East Asian Caucus to make this happen.

The Asian countries should also seek to preserve the efficacy of their trade-led economic growth. They should lead international efforts to fight the protectionist backlash from the global recession. Korea has been leading the call in the G20 for a standstill commitment against all protectionist trade policy measures which may otherwise arise to protect jobs at home in individual economies. Other Asian countries should support Korea on this, and work together to push for its effective implementation. Asia can claim a larger role in global economic governance by leading the international efforts to keep domestic markets open through the period of recession in this way.

Asia can strengthen this role further by pursuing trade liberalisation unilaterally. Korea continues to seek further opening of the domestic market by continuing the policy of building a network of bilateral FTAs around itself. Having entered into FTAs with Singapore, Chile, EFTA and ASEAN countries, the Korean government is now intent on pushing for ratification of the Korea-US FTA in the respective parliaments, and on completing the Korea-EU FTA, Korea-Canada FTA, and Korea-India FTA, in the near future. Even after the onset of

the crisis, the Korean government announced that it is preparing to launch negotiations of FTAs with Australia and New Zealand, while reviewing its present stance of reservation on a Korea-Japan FTA as well as a Korea-China FTA.

Korea's stance on FTAs seems broadly representative of the East Asian countries' trade policy strategies. Well aware of the benefits of international trade and trade integration, they tend to view trade liberalisation, rather than protectionism, as the right response to economic crisis. This being the case, the leaders of the Asian economies may want to go further than just 'standing still', and collectively pursue unilateral trade liberalisation at a regional level by launching negotiations towards an ASEAN+3 FTA or an ASEAN+6 FTA, whichever is easier to implement. In this way, Asian countries can set an example for the rest of the world to follow in resisting protectionism at home and liberalising international trade.

Given the plethora of the bilateral FTAs the country has been pursuing, Korea seems to be well positioned to provide leadership for such regional trade liberalisation move. President Lee Myung-Bak of Korea should seriously consider proposing these initiatives at the upcoming ASEAN+3 or East Asian Summit meetings.

To preserve and strengthen their trade-led economic growth, Asia needs to promote intra-regional aggregate demand, reducing dependence on extra-regional markets such as those in the United States. Region-wide FTAs, like those discussed above, may be a start. Regional financial and monetary cooperation along the lines of the CMI and ABMI can also play a role.

But beyond these efforts, the Asian economies can also work together to create new engines of regional economic growth and thus make Asia more resilient, launching coordinated investment in infrastructure, the ecological system, and 'green growth'. In parallel, they may also promote coordinated reforms behind the border, to deregulate and modernise the services sector in the individual economies. The vision of a 'resilient Asia' could be best pursued by the Asian governments by forming, and working together through, an Asia-Pacific version of the OECD. The role of the Asia-Pacific OECD would be to promote and facilitate transfer of developmental policy as well as technological know-how.

By exposing the fundamental vulnerabilities of Asian economies to external shocks for the second time, the current global financial crisis reminds Asians of the need for a new thinking as well as a new bold vision of their economic and societal progress, as well as a new approach to regional development beyond the piecemeal steps which have been taken thus far.

All these efforts to play an active, creative and constructive role in reforming the global financial architecture and enhancing the liberal trading environment, as well as to make the Asian economies as a whole more resilient by promoting intra-regional aggregate demand and creating new engines of regional growth will help facilitate the shift in global economic governance from a bipolar to a tripolar structure, and a more stable and better functioning one, with East Asia as the new, third pole.

The East Asian G20 Caucus can launch this shift by working through the Asia-Pacific Coalition. The current year, 2009, is the year of opportunity for this initiative.

REGIONAL VOICES IN GLOBAL GOVERNANCE

Lex Rieffel

A NATURAL PROGRESSION

Global summitry began in November 1975 at Rambouillet in France, prompted by the first oil shock and the subsequent international monetary crisis. The six participants were the United States, the United Kingdom, France, Germany, Italy and Japan.

Political pressures to expand participation were evident from the outset. The case for Italy's participation in this "economic summit" was based on political arguments, not economic ones. The next year, Canada was also added essentially for political reasons, In today's world, it is hard to understand why it took 24 years to create the first truly global governance forum: the G20. Even then, in 1999, the participants were finance ministers and central bank governors, not heads of state or government.

Most of the credit for inventing the G20 forum goes to Canadian Finance Minister (and subsequently Prime Minister) Paul Martin. Fending off the inevitable pressures to expand the forum beyond 20 members was a masterpiece of diplomacy. Significantly, the G20 forum included only 19 countries. The 20th seat was filled by a regional organisation: the European Union.

A major factor in the relative success of the G20 of finance ministers and central bank governors was the balance struck between

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"old powers" and "new powers." Including the European Union and Russia, ten "old powers" were matched by ten "new powers."

The regional composition was distinctly less balanced, however. Europe was significantly overrepresented—with four seats plus the EU seat. North America was represented by all three of its countries. Asia was well represented by five countries (Japan, China, India, Indonesia and South Korea), hardly excessive considering they account for 40% of the world's population. South and Central America appeared to be underrepresented, but less so with Mexico identifying more with its Latino neighbors than with the United States and Canada. Africa was arguably under-represented in political terms (South Africa only), but not so much by economic measures. The Middle East was weakly represented by two "special cases": Saudi Arabia and Turkey. Finally, Australia and Russia were also "special cases" from a regional perspective.

Two questions arise at this point. First, with the precedent of including a regional organisation leader as far back as 1977 (the EU in the G8 Summit forum), why were no other regional organisation leaders included in the G20 forum of financial ministers and central bank governors? Second, in both forums, were any of the country participants in effect "representing" other countries in their geographical region?

The first question seems to have a simple answer: In the 1975-2000 period, there were no other regional organisations approaching the stature of the EU. In the case of Latin America, the Organization of American States (OAS) had two problems. First, it was dominated by the United States. Including an OAS representative would have given the United States one-and-a-half seats at the table. Second, the OAS was hamstrung because of the US policy of refusing to recognize the communist government of Cuba.

In the case of Asia, the only regional organisation in existence throughout the 1975-2000 period was the Association of Southeast Asian Nations (ASEAN). ASEAN, however, never approached the unity of purpose and values that were hallmarks of the EU, even before Cambodia, Laos, Myanmar and Vietnam joined the initial six countries in the late 1990s. Moreover, ASEAN only acquired a formal legal status at the end of 2008, when its first charter was ratified. Even

now, with Asian regional cooperation strengthened considerably through the East Asia Summit process, Asia is a long way from being able to speak with a single voice. In essence, this is because it includes one proud "old power" (Japan) and two proud "new powers" (China and India). As a consequence of this dispersion of power, ASEAN stands at the center of Asian regional cooperation in remarkable and distinctive fashion. ASEAN is arguably the second-strongest regional organisation in the world after the EU.

In the case of Africa, the first design for a regional organisation, the Organization of African Unity (OAU), was eventually discarded and replaced by the African Union (AU).. And the Middle East even today remains deeply divided, especially by religious differences, without a strong regional organisation.

This overview begs the question of why it was necessary to include the EU in the G7/G8 Summit process back in 1977. The best answer is relevant to the broader discussion—political expediency. In other words, the second-tier European countries (notably, Belgium, the Netherlands and Sweden, initially, and more recently Spain) could not tolerate being left out of the process. Being represented via the EU was a compromise, a way of giving these countries at least part of a voice.

THE ROLE OF ADVOCACY

The question as to whether members are "representing" other countries in their geographical region has a more positive answer. Over the past 30 years, it is possible to discern a weak trend toward more countries that are actual members of the G7/G8 Summit or the G20 FM/CBG forums "representing" the interests of neighboring countries that are not members.

Starting with the G7/G8 Summit, the trend is almost invisible. In the case of the United States, there is no obvious example of reaching out in advance of a summit meeting to collect the views of Latin American countries. And no example comes to mind of the United States bringing to the summit a proposal originating in the Latin American countries. On issues of major importance to Latin America, such as the debt crisis of the 1980s, the normal pattern has been for

the United States to decide what would be best for Latin America and then pursue that approach in the summit process.

To be fair, however, there have been frequent consultations between the United States and the rising powers in Latin America. As a result, the Latin American countries have had opportunities to convey their views on issues to be discussed at each summit, and to be briefed by the United States on the results after each summit. The role of Canada is more interesting. Here, there is some evidence of Canada seeking to "represent" other countries, especially the small Caribbean nations—most visibly in the G20 FM/CBG forum as described below.

Turning to Europe, the participation of the European Union in the G7/G8 Summit seems to have pre-empted any inclination on the part of France, Germany or the United Kingdom to "represent" other European countries. The issue of Russia's role may, however, be an exception to this pattern. Without strong lobbying by France and Germany in particular, Russia may not have been brought into the G7 Summit process. This effort presumably reflected a view that none of the three European members of the G7 could fairly "represent" Russia—and that full membership for Russia was better than leaving it out, or giving it some kind of second-class observer status.

Finally, we come to Japan. There is no reason to look for any effort by Japan to "represent" other Asian countries in the G7/G8 Summit process. To begin with, there was no "Asian identity" to build on. More fundamentally, the lingering memories of World War II were an insurmountable obstacle to such a role. These memories in large part explain why Japan did not lobby to bring China into the G7 in the 1990s, when the case for doing so on both economic and political grounds was on a par with the case for bringing in Russia that the Europeans made.

Shifting from the G7/G8 to the G20 FM/CBG forum, the story gets more interesting. Forget Europe. Here as well, the participation of the EU undercuts any argument for a European member to "represent" other European countries that are not members. Forget Japan, for the same reasons cited in the case of the G7-G8 Summit process. Forget the United States. G20 members Argentina, Brazil, and Mexico would obviously be more sympathetic "representatives" of non-member

nations than the United States. And there is some evidence that these three countries have been reaching out to their Latino partners, both to enhance their own voice and to improve bilateral relations. Canada, by contrast, has made an effort here, as well as in the G8 Summit, to make the smaller Latin American countries feel as though they have a stake in the process.

Forget Turkey, Saudi Arabia, Russia, China and South Korea. An effort by Turkey to strengthen its ties to other Middle Eastern countries would have undercut its efforts to join the EU. Any effort by Saudi Arabia to "represent" other Middle Eastern countries would have undercut its aspiration to be a peer of the United States and the G7 powers. Russia can be ruled out for similar reasons. China, too, would have shied away from representing other countries in the region to avoid jeopardising its super power status, but also because of the historical legacy of conflict with other Asian countries. South Korea, for its part, is a second-tier country and has little in common with other second- and third-tier Asian countries.

We are now left with India, South Africa and Indonesia. From its first day of independence in 1947, India has promoted itself as a spokesman for Third World countries—not just in Asia but also in the rest of the world. It has an advantage in this process because of its leading role in the G24, the caucus of Finance Ministers and Central Bank Governors from developing countries that focuses on issues on the agendas of the IMF and World Bank. It is not clear, however, that this role has carried into the G20 FM/CBG forum in any systematic way. Another problem for India is its history of tension-filled relations with major neighbors (Pakistan and Bangladesh), and the small number of other countries in the South Asia region.

By contrast, South Africa and Indonesia both have a "representation" role that is quite visible. For South Africa, the diplomatic pressure to represent other Sub-Sahara African countries is intense, as there are no other countries from this region in the G20 FM/CBG forum. Also, the spirit of African solidarity remains strong. Complicating this role, however, is the fact that South Africa is considerably more advanced institutionally and structurally than most other Sub-Sahara African countries. Therefore its own views on global issues often do not align easily with those of its regional partners.

For Indonesia, the driver of its role "representing" the ASEAN Community in the G20 FM/CBG forum is the idea of a multi-dimensional, regional community. Indonesia's role has been reinforced by being the ASEAN country with the largest population (by a factor of two and a half)—and more recently having engineered a remarkable transition to a democratic political system. ASEAN finance ministers and central bank governors meet on a regular schedule. These meetings are used by Indonesia to solicit views from its ASEAN partners on the issues to be discussed in upcoming G20 FM/CBG meetings (including affiliated working groups) and to report on the discussions at recently concluded meetings. The spirit of this role is captured in a recent quote from Indonesia's Planning Minister: "Indonesia as one of ASEAN's ten member countries must, of course, accommodate the interests of all ASEAN nations."

CHANGING THE G8?

The G20 Summit in Washington in November 2008 clearly represented a breakthrough in global governance, prompted by a global crisis as has so often been the case. The Europeans—especially President Nicolas Sarkozy and Prime Minister Gordon Brown—deserve the credit for convening a global summit to focus on the crisis rather than a G8 Summit.

The decision to start with the G20 FM/CBG in designing the Washington Summit at least reflects the US government's grudging acceptance of the broad international consensus that the G8 Summit process has outlived its usefulness. The relatively quick and easy agreement to follow up with a similarly designed London Summit in April 2009 underscores the shift away from the G8. The G8 Summit process was already morphing to include more "new powers." In particular, at the 2007 Summit in Heiligendamm, Germany, the participation of five leading emerging market countries (Brazil, China, India, Mexico, and South Africa) was semi-formalised.

In other words, it was understood that these five countries would be invited to future G8 Summits. However, they were not accorded the status of full "members," which led to the media spin that they were just being invited to join in the coffee breaks.

Despite the move toward a G20 forum at the Washington and London Summits, the G8 Summit process is still alive for several reasons. The simplest reason is that Italy has been preparing for years to host the 2009 Summit (in July, on La Maddalena, a small island north of Sardinia). It would be a gross affront to Italy to "pull the plug" on this summit. A second reason for not abandoning the G8 Summit now is that a consensus does not exist among the "old powers" and the "new powers" on who to include in a broader global governance forum to replace the G8. While there are passionate advocates of the "simple" solution of adopting the G20 FM/CBG geometry, strong arguments in favor of different-–and generally smaller—configurations have been advanced in recent years.

The issue is coming to a head, and the position of the United States will be critical. Despite the wounds it has administered to itself over the past eight years or more, no other country has a better claim to be the world's leader. Moreover, the election of President Barack Obama has captured the world's attention and given him immense personal influence in the international arena.

Italy has an unenviable task. Its narrow national interests strongly favour preserving the primacy of the G8 Summit. It clearly understands, however, that the success of the July Summit depends in large part on having the "new powers" participate meaningfully—even if not accorded the formal status of full members. Italy has also seen how difficult it is to hold the line against pressures to add participants.

To the surprise of many outside experts, it turned out that participation in the Washington Summit was not limited to the members of the G20 FM/CBG process. The leaders of Spain, Netherlands, and the Czech Republic managed to shoehorn themselves into the meeting. No official announcement has been made about whether the leaders of these three countries will be at the Summit on La Maddalena or not, but it would be remarkable if Italy musters the courage to exclude them.

For a while, question marks also existed over the participation of the six countries that are members of the G20 FM/CBG forum but are not in the five-country Heiligendamm group: Argentina, Indonesia, South Korea, Turkey, Saudi Arabia, and Australia. At the beginning of

March, however, Prime Minister Berlusconi announced that "we will have the G20 as well on the third day".

Just the month before, in elaborating on Italy's concept of "variable geometry", Prime Minister Berlusconi added Egypt to the list of Summit participants "to represent the Arab, Muslim and African world". In short, the G8 Summit in July will involve even more global leaders than the November 2008 Summit in Washington and the April 2009 Summit in London.

End of story? Will the G8 Summit have morphed into the G20 Summit? Maybe and maybe not. We need to look over the horizon to the future meetings that are penciled into the calendars of the G8 Summit and the G20 FM/CBG forum. The United Kingdom is hosting the London Summit in April because it is the chair of the G20 FM/CBG forum for 2009 according to the pre-arranged rotation. The past rhythm for this forum has been for the Ministers and Governors to meet once a year in November. Surely, the United Kingdom will not want to give up its turn to host the G20 this coming fall. Nor is it likely to let the level of participation revert to finance ministers and central bank governors. Even if the world economy is firmly on the road to recovery by then, Prime Minister Brown will want to seize the opportunity to make progress on other pressing global issues such as climate change.

Depending on the agenda, however, participation in the fall 2009 G20 Summit might be adjusted a bit. Why? Because by the summer, the United States may have concluded that a somewhat different geometry is better, especially one in which Europe is not so over-represented. And the United States is likely to work in partnership with the United Kingdom to begin moving toward a better-balanced forum.

LOOKING TO 2010

Summitry in 2010 could be awkward. Canada will be chairing the G8 Summit and South Korea will be chairing the G20 FM/CBG forum. The awkwardness comes from both countries having a weak claim to membership in a lean global governance forum. Canada's case is weak because its participation would mean that all three North American countries are members, which is untenable from the perspective of the rest of the world.

South Korea's case is weak because Asia is over-represented, and its own population is so much smaller than the other Asian members (China, India, Indonesia and Japan). It is, nevertheless, easy to imagine something modeled on the Washington and London summits—one hosted by Canada in the first half of 2010, and one by South Korea in the second half.

The prospects for 2011 are more intriguing for two reasons. First, it will be France's turn to chair the G8 Summit. Second, while no formal decision has been made, the United States could chair the G20 FM/CBG forum. This coincidence could present an exceptional opportunity for change. France was the first country in the G8 rotation cycle. In other words, the G8 Summit in Canada in 2010 completes the fifth cycle. Instead of beginning a sixth G8 cycle, France could have the honor of hosting the first summit of a replacement global forum. Similarly, a G20 Summit in Korea in 2010 would complete the second cycle in the G20 FM/CBG rotation.

Instead of beginning a third cycle, the United States could defer to France (which is in "group four" but has not yet been in the chair for the G20 FM/CBG forum) so that France could chair a combined G8/G20 Summit in mid-2011. The transition to a lean and well-balanced global summit forum, replacing both the G8 and the G20, could then be completed in 2012. This is when, according to the existing G8 Summit rotation, the United States will be the host country. With President Barack Obama still in his first term, this could be the ideal moment for such a move.

Two critical questions remain to be addressed. First, which countries should be included as "core members" of the new global summit? And second, can some formula for regional representation be developed? With respect to core membership, the direction of change from the current G20 FM/CBG configuration seems clear: one less European country (Italy), two fewer "old powers" (Australia and Canada), one less Latin American country (Argentina), and two fewer Asian countries (Indonesia and South Korea). More problematical is dropping the two Middle Eastern countries (Saudi Arabia and Turkey), and the only African country (South Africa).

This would yield a core membership of ten countries, five "old powers" (France, Germany, Japan, United Kingdom and United

States) and five "new powers" (Brazil, China, India, Mexico, and Russia). A summit forum limited to these ten countries, however, seems too restrictive. Some build-out will probably be necessary, and some flexibility. Two kinds of flexibility are possible: ad hoc selection and regional representation.

Which countries should be included as "core members" of the new global summit? And can some formula for regional representation be developed? With ad hoc selection, each year's summit chair would invite, for example, the leaders of five additional countries, depending on the issues of the day. As an example of regional representation, five regions would select a single leader to represent the non-participating countries in the region.

Conveniently, the world divides easily into five "under-represented" regions: Europe, the Middle East, Africa, Southeast Asia, and the Americas. The regular regional leaders could be the heads of a regional organisation (e.g., the President of the European Union), or they could be the heads of state or government from a dominant country (e.g., Indonesia as the natural leader of the ASEAN Community).

Part of the deal to create this new summit forum could be a review of participation every five years, with a view to making the forum more representative and efficient. The good news is that nothing needs to be decided quickly. The debate over the geometry of a new global governance forum at the summit level can extend comfortably over the next 2-3 years as the world digs itself out of the current crisis. Since the shape of the post-crisis world is hard to predict, there is even a strong case for putting off any serious discussion for at least a year.

In the meantime, there is plenty of urgent work to be done to restore global growth, reduce imbalances and strengthen the international financial system.

THE ROLE OF APEC AND THE WTO IN MARKET-DRIVEN INTEGRATION

Andrew Elek

INSTITUTIONAL OPTIONS

The GATT/WTO system has been a huge success. It has created a rules-based global trading order where most products do not face significant traditional border barriers, such as tariffs and quantitative restrictions; allowing a steadily growing number of economies to trade their way out of poverty.

But it is no longer efficient to rely solely on an institution which was created to deal with international trade as it was 60-70 years ago, when it was still dominated by commodities and finished manufactures.

An international trading environment where most products face low formal border barriers to trade needs to be complemented by:

- reducing uncertainty about future market access: for example anti-dumping actions or other arbitrary or discriminatory measures to deal with trade tensions;
- reducing physical and administrative bottlenecks, such as shortfalls in infrastructure, ranging from harbours to telecommunications;
- harmonising domestic legislation and rules, such as those relating to competition policy or product and process standards.

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The need to deal with these issues is, at last, becoming well understood. But it is still assumed that we have to deal with the remaining traditional border barriers to trade before we move onto these other dimensions of integration.

Both the WTO and PTAs seek to tackle both sets of issues at the same time. In the WTO, progress is held up by the difficulties of dealing with sensitive products like agriculture and labour-intensive manufactures. The Doha Round will, nevertheless, be concluded in due course. But that will leave many more issues to resolve. It is no longer possible to expect all dimensions of economic integration be dealt with by WTO Rounds.

On the one hand, the WTO negotiating agenda is already too wide; so achieving a single undertaking takes far too long. On the other hand, the agenda is also too narrow; it is no longer able to cope with all the new dimensions of international economic transactions and the impediments to them. These shortcomings of the WTO are accelerating the growing reliance on preferential trading arrangements (PTAs). Their proliferation will not end with the end of the Doha Round.

With careful choice of partners and a cavalier interpretation of WTO disciplines on discriminatory trading arrangements, PTAs can be negotiated while largely avoiding politically difficult decisions to liberalise trade in sensitive products.

By avoiding the most sensitive issues, PTAs can be completed much more rapidly than WTO negotiating rounds. These bilateral or regional deals can lock in low rates of protection for almost all goods and they are making useful progress on trade in services. They are also beginning to address new issues, such as regulatory impediments to international commerce. However, PTAs are promoting integration only with trading partners which do not threaten deeply entrenched producer interests.

PTAs rely on discriminatory, product-specific rules of origin to avoid indirect competition to sensitive products. Such rules of origin run counter to market-driven globalisation and impede opportunities for fine specialisation along lines of comparative advantage to take advantage of falling costs of transport and communications.

There is growing concern about the convoluted network of overlapping PTAs, relying on trade-diverting rules of origin, but no government can risk being left out of PTAs.[1] The concerns about proliferation of bilateral PTAs are leading to attempts to link and rationalise them. However, it is not easy to expand the membership of preferential arrangements, many of which have been tailor-made to avoid hard political decisions of existing members.[2]

There is certainly no realistic prospect of negotiating a Free Trade Area of the Asia Pacific which would lead to genuine free trade among all APEC economies. An attempt to negotiate an APEC-wide agreement would need to deal with those same difficult issues which have slowed WTO negotiations and could not be completed in any meaningful timeframe. Moreover, any eventual outcome could only lead to a lowest common denominator result on border barriers, while delaying any alternative means of addressing all the many other dimensions of economic integration.[3]

If APEC tries to deal with all issues at once to negotiate a single FTAAP undertaking then we risk the same fate as the Doha Round. There would be protracted negotiations, with progress held hostage to the vested interest of ageing Japanese rice farmers and billionaire Florida sugar barons.

LOOKING BEYOND TRADE NEGOTIATIONS

Fortunately, there is no need to negotiate a comprehensive APEC-wide agreement before making worthwhile, progress in terms of ever-

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[1] It is beyond the scope of this presentation to set out more of the arguments for refocusing attention to multilateral negotiations, rather than on hundreds of more PTAs. Jagdish Bhagwati (in *Termites in the Trading System: How Preferential Agreements Undermine Free Trade* (Council of Foreign Relations) 2008) and Victor Fung (see above) have done so from an analytical and a practitioner point of view, respectively.

[2] For example, the new PTA linking the 10 ASEAN economies with Australia and New Zealand contains a clause that the new agreement does not override any of the provisions of existing agreements involving the participants. Negotiations continue to conclude further bilateral PTAs among the economies involved, so the new 12-member agreement has had a limited effect in terms of rationalising the proliferation of agreements.

[3] As an example of one of the many difficult issues which would need to be confronted: a meaningful agreement involving the United States and major East Asian economies would require a significant renegotiation of the North American Free Trade Agreement (NAFTA) rules of origin designed to avoid new competition from East Asian imports.

deeper economic integration among all the Asia Pacific economies that want to do so.

There certainly no need to assume that promoting integration among pairs, or groups, of economies needs to begin with dealing with the remaining border barriers to trade in the few sensitive products which remain protected by traditional border barriers. Impediments to trade, investment and other international economic transactions can be grouped into:

problems where short-term costs are perceived to exceed long-term benefits, so that negotiations are needed for progress; and

other matters where there is a shared perception of mutual benefit from cooperation: in these cases, cooperative arrangements to reap the shared benefits do not need to be negotiated.

Once we divide the potential dimensions of cooperation into those which do, or do not require negotiations, we can see that they can be viewed as international games. On closer examination, cooperative arrangements to reduce many of the costs and risks of international economic transactions are positive-sum games where negotiations are not necessary.

It is worth noting that the above classification of opportunities to promote economic integration is not the same distinction as the one between trade liberalisation and trade facilitation.

The well-understood political economy of trade liberalisation explains that, for the foreseeable future, further reduction of theprotection of currently sensitive products will require negotiations

However, negotiations have not been needed for all dimensions of trade liberalisation. For example, much of the actual liberalisation of applied rates of protection of most products and extensive liberalisation of restrictions on direct foreign investment have been made unilaterally, not in the context of negotiations. That has certainly been the case in Australia and China. In another example, the APEC-wide, then WTO, agreement to prevent restriction of trade in information technology products did not require difficult negotiations.

The many challenges of trade facilitation can also be grouped into those which do, or do not require negotiations. For example, it may be necessary to negotiate mutual recognition of some products standards or professional qualifications in return for mutual recognition of others.

On the other hand, seizing many opportunities to reduce costs or risks of international commerce do not require negotiations, since they are already perceived to be positive-sum games, leading to cooperative arrangements which are in the interest of all participants in these arrangements. Practical examples include the many opportunities to efficiency and security of supply chains with, as already noted, potentially huge economic returns to all the economies involved.

On issues such as improving business mobility or better trade logistics, negotiations are not only unnecessary, but they not sufficient. Any tangible, practical progress needs more than statements of intent: The effective constraint on action is not political will, but the capacity to design and implement compatible institutions and procedures.[4]

A distinction of opportunities to promote economic integration into positive-sum games which do not require negotiations and other games where negotiations are needed should also lead to an efficient division of effort between institutions.

Institutions like APEC, where cooperation is voluntary, can expect to make progress on matters where cooperation is already perceived to be positive-sum game. The successes of the APEC process have, indeed, been in areas where progress was seen to be of mutual benefit or in perceived self-interest of member economies.

As set out in the 2005 mid-term stocktake of progress, APEC governments have made substantial progress. There has been significant unilateral of traditional border barriers to trade, encouraged by means of peer pressures and a broad commitment to move towards free and open trade and investment. Voluntary collective action among Asia Pacific economies is already saving billions of dollars per year by practical cooperation to reduce administrative and logistic delays and costs, for example by harmonising customs procedures.[5]

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4 Almost all recent PTAs contain chapters dealing with opportunities to facilitate trade or investment, for example by enhancing the business mobility and encouraging greater use of e-commerce. Typically these are statements of positive intentions. Substantive cooperation on these behind-the-border issues then requires capacity-building. For example, free movement of business people cannot be achieved by negotiation, but needs patient work to set up compatible information technology to allow such movement to be combined with obvious security concerns.

5 See APEC, "Mid-term stocktake of progress towards the Bogor goals: Busan Roadmap to Bogor Goals" ,endorsed by APEC leaders, November, 2005.

Conversely, the APEC process has not made appreciable progress in areas where short-term political considerations outweigh potential long-term benefits. In these areas, such as reducing remaining border barriers to trade in sensitive goods or services, negotiations are needed.

Such negotiations cannot be conducted in a voluntary process of cooperation like APEC; they need to be left to the WTO or negotiations among smaller groups, or pairs of economies.

A NEW DIVISION OF EFFORT

Based on the above discussion, it should be possible to agree on a logical division of effort in terms of promoting market-driven economic integration.

Policy-makers could agree that promoting economic integration (liberalisation or facilitation) does not always need to be negotiated. They should then accept that voluntary processes of cooperation have comparative advantage in dealing with issues where negotiations are needed, but have no comparative advantage in trying, then failing, to deal with issues where negotiations are needed. Issues where negotiations are needed should be left to institutions or processes designed to conduct negotiations.

We could then use processes and organisations like APEC to help design and implement cooperative arrangements to seize potential mutual benefits where negotiations are not needed. As discussed already, there is enormous scope for all-round gains from work on mutual recognition of standards and harmonising administrative procedures, including to improve the efficiency and security of supply chains.

On other issues where negotiations are needed for short-term progress on liberalising or facilitating trade and investment, it should be possible to use the WTO. Both APEC and the WTO need new strategies and new sense of direction to rise to the many remaining challenges of economic integration.

THE LIMITS OF ASIA PACIFIC COOPERATION

For much of its life, the APEC process has been distracted by calls to negotiate an APEC-wide trade deal (in the 1990s it was called PAFTA, more recently it is called a FTAAP). As already explained, this

is not a realistic prospect, but the pressure for APEC to try to imitate the WTO is not likely to recede for some time. This distraction will continue to limit the capacity to deal with the matters where APEC has comparative advantage. APEC will continue to do useful work on facilitation, but on a very modest scale, falling well short of the vast potential of APEC to integrate Asia Pacific economies.

While many dimensions of economic integration, particularly trade facilitation, do not need negotiations, that does not mean they are easy. Implementing practical arrangements, for example to improve supply chains need capacity building. For example, the returns from investment in transport infrastructure are multiplied if combined with programs to strengthen human resources, policy frameworks and institutions.

A wide-ranging, capacity-building effort to support many opportunities to facilitate trade and investment will need substantial human resources. And deploying a large number of people with relevant expertise to support APEC-wide capacity-building efforts will need financing which is considerably greater than the capacity-building resources currently available to APEC, including from bilateral development agencies.

The challenge is to mobilise more resources for capacity-building, without turning APEC into an aid organisation. APEC is not designed to implement large, region-wide capacity-building programs. Moreover, the resources needed are well in excess of what APEC governments would grant to an APEC bureaucracy.

Just as APEC needs to learn to use the WTO, rather than to imitate it, APEC will need to learn to catalyse the resources needed for mutually beneficial economic integration in the region from the private sector and international financial institutions such as the World Bank and the Asian Development Bank.[6]

The APEC process has not been able to do much along these lines so far. And it will not be able to do much better while the attention of APEC leaders is distracted by the futile dream of a FTAAP.

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[6] See Andrew Elek, "APEC after Busan: new direction" *APEC Study Series*, 05-01, Korean Institute for International Economic Policy, November, Seoul for further discussion of the need to mobility resources for capacity-building

FOCUSING THE WTO

Unlike earlier rounds, the Doha Round of WTO negotiations are not likely to be followed by another. There are too many issues and too many players to expect a worthwhile outcome in a reasonable time. That creates a high risk that most negotiations to reduce those impediments where negotiations are still needed will shift to more and more PTAs.

To avoid a continued drift away for non-discriminatory trade, the WTO needs a new strategy. It is urgent to escape from the self-imposed constraint of seeking a single undertaking on a wide range of often unrelated issues. Experience has shown that it is possible to deal separately with different set of issues in the WTO. The plurilateral protocol of government procurement and the WTO information technology agreement are useful precedents. It should be able to build on them. Options include:

Negotiations focused on limiting the uncertainty due to the scope for WTO-consistent protectionism, for example by contingent protection, such as anti-dumping and trade-distorting subsidies, and the option of raising applied rates to bound rates of protection.[7]

Negotiations on trade in services could lead to an agreement which consolidates the gains which are being made in PTAs.

A plurilateral agreement on international investment.

The information technology agreement and the ongoing work towards free trade in environmental products could lead to an agreement to immunise all new products from rent-seeking protectionists.[8]

Seeking consensus on limiting new protectionism as part of the negotiations to limit greenhouse gases in the atmosphere.

If the WTO could concentrate on a few issues which governments and the private sector both see as important, rather than trying to negotiate everything at once, there would be less need to resort to discriminatory PTAs.

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7 Aaditya Mattoo and Arvind Subramanian have called for a crisis round of WTO negotiations to address this set of issues (Article in *VoxEU.org*, March 30, 2009, available at http://www.petersoninstitute.org/publications/papers/paper.cfm?ResearchID=1173

8 See Andrew Elek, "Immunising future trade against protectionists: preventing the emergence of more sensitive sectors", Asia Pacific Economic Papers, No.372, Australia-Japan Research Centre, Crawford School of Economics and Government, Australian National University.

In many cases, negotiations can be conducted among those governments who are genuinely interested in dealing with such issues. Progress need not be held hostage to the most recalcitrant. The gains from new agreements will accrue mostly to those involved. The costs will largely fall on those who forego the opportunity to shape new agreements on important new issues. To protect the long-term interests of those not initially involved in plurilateral arrangements, it would be essential to design all new arrangements so that others could join them as soon as they demonstrated their willingness and ability to adhere to relevant disciplines and undertakings.

APEC leaders represent a very significant proportion of the global economy. It could be possible for them to exercise collective leadership in the WTO to set such a new strategy and the agenda for the coming decade. Unfortunately, APEC leaders have not been able to act cohesively on strategic issues in the WTO so far.

It may be necessary to look to the G20 to bring about major reform.

THE GLOBAL CRISIS AND ASIA-PACIFIC

Anwar Nasution

INTRODUCTION

It is impossible to predict the nature and extent of the damage that the current global economic crisis will inflict and how long the world and the Asia-Pacific economies will suffer from the ensuing low economic growth. The recession will hit the economies of this region hard through falls in commodity prices, declining trade, capital outflows and lower remittances from citizens working overseas. As this region has neither sufficiently robust domestic demand, nor large intra-regional trade to offset the impact of falling exports to the United States and Europe, countries in Asia-Pacific should adopt a two-prong approach to the crisis. Internally, they should foster closer policy cooperation to make better use of the region's financial resources and relatively large domestic markets in order to speed up economic recovery.

In the long term, the expansion of potentially large domestic markets can gradually replace the current export-oriented development strategy of many countries in this region. Globally, this region should work hand in hand with other regions, particularly with the relevant authorities in their main export markets in the US and Europe, to promote world economic growth in line with the APEC ethos of

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open economies, and resist the temptation of protectionism. All of these require closer cooperation on monetary and fiscal policies and exchange rate policy, both regionally and globally. Otherwise, Asia-Pacific may well experience a "lost decade" like that suffered by Indonesia following the Asian financial crisis in 1997-98, or by Japan in the 1990s.

The crisis has been strengthening the position of the US as the global financial superpower. US financial institutions are now consolidating to become giant financial conglomerates. The US Treasury and the Federal Reserve Bank are able to issue billions of dollars in debt at close to zero nominal interest rates—lower than the inflation rates. Negative real interest rates mean that rather than paying interest rate, the US Government actually gets paid for borrowing money.

People around the world are now so risk averse, and the scramble for both safety and liquidity so strong, that they are hoarding the safer US dollar, US Treasury bills and US long-term government bonds. Massive capital inflow has allowed the US to finance its budget and balance of payment deficits and provide funds for rebuilding its financial system, stimulating its economy, recycling funds to provide dollar liquidity to foreign central banks through the Federal Reserve Bank's bilateral currency-swap facilities, and for financing the expensive wars in the Middle East.

The world economic downturn is being exacerbated as all sectors in the economy stop spending. Deterioration in borrowers' balance sheets due to faltering mortgages and stock markets, foreclosures and bankruptcies have worsened credit risks and made the problems of adverse selection and moral hazard more prominent. Both banks as well as companies need to deleverage to improve their liquidity positions, reduce dependency on wholesale funding and rebuild profit margins. As a result, the banks have stopped lending, businesses have stopped investing and lending to each other and households are refusing to spend. All of this has reduced the velocity or turnover of money-to-service transactions in the economy. At a given money supply, the fall in the velocity of money will reduce gross domestic product, which is the multiplication of the two monetary variables.

The rest of this note is organised as follows. Section 2 analyzes the evolution of the global financial crisis and contrasts it with the

Asian financial crisis of 1997-98. Section three examines the current economic situation in Asia Pacific. Section four describes global and regional responses, and the final section sets out my recommendations for policy coordination in the region to promote global economic recovery.

THE GLOBAL FINANCIAL CRISIS

Similar to the Asian financial crisis of 1997-98, the current sub-prime mortgage debacle, which erupted in the United States in the summer of 2007, was precipitated by a crisis of confidence among short-term creditors that caused them to withdraw funds from the shadow banking system. Over the years, the shadow banks relied on short-term collateralised lending in the form of repurchase agreements[1]. The shadow banking system includes finance companies, hedge funds and investment banks that buy mortgages and loans from banks, as well as corporate bonds and other assets, like credit card receivables, automobile and student loans, and repackage and sell them in sophisticated but arcane ways to financial investors around the world.

The increase in the delinquency rates of sub-prime mortgages eroded the collateral value of the assets of the highly leveraged shadow banks and, at the same time, caused maturity mismatches on their balance sheets as they borrowed short and lent long. The drop in market prices and liquidity adversely affected the capital and solvency of shadow banks, raised the funding needs of all financial institutions and reduced their access to the lending markets.

The supply of funds further diminished as creditors and uninsured depositors pulled their funds from risky institutions and transferred them to safer bets. This made the financial institutions vulnerable to runs and resulted in them hoarding their liquidity, and to interest rate surges in the short-term money markets. Gridlock in the markets for certain asset-backed securities occurred as institutions were unable

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1 See Markus K. Brunnermeier,2008, "Deciphering the 2007-08 Liquidity and Credit Crunch". *Journal of Economic Perspectives* (forthcoming). Draft. 19 May , and David Greenlaw, Jan Hatzius, Anil Kayshyap and Hyun Song Shin. 2008. "Leveraged Losses: Lessons from the Mortgage Market Meltdown." *US Monetary Policy Forum Conference* Draft. www.chicagogsb.edu/usmp/docs/usmp/2008confdraft.pdf.

to pay their obligations because others were not paying theirs. On the other hand, the demand for credit by companies and household decreased due to the economic recession and reduced values of their assets.

A number of policies were adopted to deleverage the balance sheets of the shadow banks, such as by tightening lending standards, improving credit quality, reducing the volume of loans, and selling assets. However, the simultaneous attempts by so many institutions to deleverage depressed asset prices and produced additional losses. As it is nearly impossible to determine market prices for certain asset-backed securities, they cannot be used as collateral for new funding to borrowers.

The credit crunch in the US financial markets spread quickly around the globe. By mid September 2008, after 13 months of market stress, short-term credit markets froze and the interbank markets of many countries were disrupted as the banks stopped lending to each other. The process of flight to safety began with the hoarding of cash by investors, the pulling of capital from perceived weak institutions and the shifting of portfolios to government bonds, mainly US Treasury bills. Short-term interest rates surged, far above central banks targets, on fears that many leveraged financial institutions might collapse due to lack of short-term credit.

Some banks in the US (Wachovia) and Europe (the Northern Rock, IKB, Bradford & Bingley and Fortis) were either taken over by stronger institutions or nationalised. In this region, Bank of Asia in Hong Kong experienced a small bank run, Bank Century, a small bank in Indonesia, was taken over by *Lembaga Penjamin Simpanan* (Indonesian Deposit Insurance Corporation) on 21 November 2008, and a further four banks in the Philippines were taken over by the Philippine Deposit Insurance Corporation (PDIC), in addition to 9 small banks placed in PDIC receivership by order of the Central Bank of the Philippines.

The credit crunch has reduced the flow of financing for the economic activities of both companies and households, which has exacerbated the economic downturn, and in turn weakened financial institutions and intensified the credit crunch. Uncertain about demand for their products, both in domestic and export markets, and unsure

about how to finance their activities, nonfinancial firms reduced production and cut demand for inputs, including raw materials, oil and labour. The credit crunch and high interest rates have encouraged them to repay debt, reduce spending and put investment plans on hold. At the same time, the credit crunch has also left households with fewer resources to finance spending.

CURRENT SITUATION

The negative effects of the crisis filtered into the export-oriented Asia Pacific economies through the current and capital accounts of the balance of payments. Foreign demand for this region's exports fell sharply as the deeply interconnected world economy began to show signs of having entered a dangerously downward spiral: recession or low economic growth, falling commodity prices, rising unemployment, faltering stock markets, exchange rate realignments, collapsing property values, the implosion of hedge funds, foreclosures, bankruptcies and write-offs, as well as a credit crunch. The fall in demand has resulted in unsold stock piling up, higher excess capacity and signs of deflation.

International and regional banks and institutions have been revising their economic forecasts downward with depressing frequency. The IMF forecast for world economic growth for 2009 was revised downward to 0.5% in January 2009 from 2.2% in November 2008. The group of advanced economies is forecast to contract by -2% over the whole of 2009. Japanese economy is predicted to shrink by -2.6%. Because of the fading in demand for mining resources and global economic crisis, the Australian economy is projected to contract by 0.2%t in 2009.

The highly export dependent economy of Singapore is expected to shrink between 2% to 5% in 2009. This is mainly due to the falling demand for its export products, such as petrochemicals and electronics. China is projected by the IMF to grow by 6.7% in this year, lower than the average annual rate of 9% over the past few decades. This is lower than the minimum rate of growth at 8% to absorb new entrants to the labour market. Newly Industrialised Asian Economies are predicted to contract by -3.9% and ASEAN-5 is to grow by 2.7%.

Euler Hermes[2], a subsidiary of Allianz Insurance of Germany, is predicting that corporate bankruptcies in the advanced economies of Europe, the US and Japan will hit a record this year. The highest annual increase in company failures in 2009 will be in the US at 50.4%, followed by Western Europe at 16.7% and Japan at 7.9%. A number of airlines and automobile companies around the world, including General Motors, have received equity injections from governments to keep them in operation. Toyota Motor, the best run and most profitable car producer, suffered its first loss in 2008 since it began its financial reporting 68 years ago[3] and some of its assembly plants have been temporarily closed. Labour disputes and riots are increasing in China as a result of the closure of labour-intensive export-oriented manufacturing firms, and the ensuing redundancies.

The economies of the emerging countries in this region are very much driven by foreign capital inflows. This is because of the high dependency of companies and the banking system, and to some extent the public sector, on foreign financing. The emerging economies in this region are also prone to capital outflows. Benefiting from the economic and commodities boom, they had regained the confidence of international investors after the Asian financial crisis of 1997-98. Private investors, however, are now pulling their funds out of South Korea, Taiwan, Thailand, Indonesia, and the Philippines.

Falling commodity prices and export revenues, and rising unemployment in labour importing economies have dealt a triple blow to commodity dependent and labour surplus emerging economies, such as Indonesia and the Philippines. Political instability has hit the tourism industry in Thailand. Sharply reduced revenues from both exports and labour remittances, together with capital outflows, mean that these countries will need to cut spending and let their currencies depreciate. The rise in unemployment in labour importing economies, and the ensuing deportation of foreign workers from these countries, has increased the pressure on the labour markets of the labour surplus countries. Unemployment, healthcare and job-retraining assistance

[2] "Company crashes set to hit record next year." *Financial Times*. Monday, 8 December 2008. Companies and Markets. p. 19.

[3] "Toyota to suffer first loss in 68 years", *Financial Times*, Asia, Tuesday, 23 December 2008, 1.

are practically non-existent in these countries, which are mainly emerging economies. Prolonged economic hardship could cause political instability and social unrest in densely populated countries that could end up being exported globally.

The crisis has also seriously affected banking systems in this region and eroded the value of foreign assets and external reserves. The stronger capital bases, better supervision of the banking system, and larger external reserves that have been built up since the Asian financial crisis of 1997-98 have proved inadequate to overcome foreign exchange illiquidity, particularly as regards the US dollar, with the result that the settlement of international transactions has been affected. Fortunately, the exposure of financial institutions in this region to US collateralised debt obligations (CDOs) arising from sub-prime mortgages is relatively small. This has saved the region from the sort of bank failures that have occurred in Europe. In addition, the home-grown subprime market is relatively small in this region, as household debt is insignificant and the shadow banking system is underdeveloped.

RESPONSES

The first policy response of all countries to overcome the crisis is to restore the flow of credit to avoid a deeper recession and to stabilize the financial system. The second policy response is to prevent further deterioration in economic activities by expanding aggregate demand. As traditional monetary policy has proved ineffective in promoting the expansion of consumption and investment, central banks are now switching to monetary easing and greater reliance on fiscal policy as an instrument for restoring economic growth. The use of fiscal policy that will cause unprecedented budget deficit, however, can only be used temporarily while fixing the dysfunctional credit markets caused by the uncertain value of asset-backed securities. This is because not all of the government spending is desirable and necessary and many of them are wasteful. Prolonged large deficit spending can cause a detrimental effect on the solvency of the economy.

RESTORING CREDIT MARKETS

With the non-functioning of short-term credits and inter-bank money markets, commercial banks around the world have turned to

central banks as lenders of last resort for liquidity. A central bank is a powerful monetary authority, which controls the supply and demand for high-powered money, or the monetary base. The source of monetary base consists of gold and foreign exchange reserves administered by central banks and their loans outstanding to government, commercial banks, and, during crises, directly to businesses.

There are two principal uses of monetary base, namely, currency and bank deposits with central banks. The central bank has a monopoly right over the issuing of bank notes, coins, and sets the minimum reserve requirements for the commercial banks. The reserve requirement ratio requires commercial banks to keep a certain fraction of their deposits as reserves, and hence, just like a tax on bank deposits, reduces their capacity to lend and invest. Normally, central banks expand money supply by buying short-term government papers, such as Treasury bills, and paying for them by printing money.

To contract the money supply, central banks sell government papers and withdraw money from circulation. Central bank activities designed to affect the money supply through the buying and selling of government papers are referred to as open market operations (OMO). In the absence of short-term government securities, as in the case of Indonesia, the central bank creates its own short-term debt instruments. As the bankers' bank and lender of last resort, a central bank also offers short-term credit facilities to the commercial banks.

At the beginning of the crisis, the US Fed encouraged banks to borrow using the discount window facility by lowering the penalties on such borrowing. The discount window is used as an instrument to influence the reserves of the commercial banks and hence money supply. The facility is backed up by government securities and has a very short-term maturity, usually overnight. Through the discount window, central banks can set their policy rates, discount rates, fees for loans and the quantity of loans. Banks are reluctant to borrow from the discount window as very often market participants will perceive them as being in trouble and may begin to pull their funds. In December 2007, four months after the crisis erupted, the US Fed introduced three new lending facilities with wider collateral requirements and longer maturities.

On the international front, the US Fed has coordinated its monetary policy with other leading central banks so as to provide liquidity to the globalised interbank and money markets, and has cut its nominal discount rates to close to zero at the present time. The US Fed has also established temporary bilateral currency swap facilities with 14 central banks to allow participating institutions to draw down balances denominated in the US dollar to meet their needs in that currency[4]. Governments, banks, companies and investors outside the US have borrowed huge amounts in dollars. However, renewing these loans and rollover corporate and sovereign debts has become more expensive, especially for emerging economies. The combination of rising interest rate and tightening lending standard has made it more difficult for these economies to repay the debts. This problem is likely to continue after the crisis.

Similar swap facilities have also been established by the ECB and, in line with the Chiang Mai spirit, by central banks in this region. Similar to credit lines from international and regional financial institutions, bilateral currency-swap facilities add to the foreign exchange reserves of the recipient countries. However, despite all of these policies designed to expand lending facilities and cut policy rates, credit markets remain frozen, bank lending to businesses and consumers remains stagnant, and interest rates remain high. According to Taylor and Williams, central bank target interest rates have become disconnected from the overnight rates. This is partly because the markets are uncertain about US policy regarding the losses on sub-prime mortgages, with the result that interbank interest rates and the cost of borrowing have been pushed up[5].

As normal procedures have proved ineffective in restoring the proper functioning of interbank and money markets, the US Fed has revised its procedures by switching to monetary easing. Pumping liquidity into the economy has not worked, however, because of the liquidity trap as nominal interest rates are now close to zero and

[4] The central banks are those in Australia, Brazil, Canada, Denmark, ECB (the European Central Bank), Korea, Japan, Mexico, New Zealand, Norway, Singapore, Sweden, Switzerland, and the United Kingdom.

[5] John B. Taylor, and John C. Williams, 2009, "A Black Swan in the Money Market," American *Economic Journal Macroeconomics* 1, no.1. 1(January): 58-83.

already negative in real terms. As interest rates have nearly hit the zero boundary, the Fed cannot push them much lower. With interest rates close to zero, Treasury bills are transformed into the equivalent of cash, as both of them become perpetual government bonds that carry no interest.

In the liquidity trap, the demand for money is infinitely elastic. Because of this, people prefer cash to bonds as the future rise in interest rate would consequently cause a fall in bond prices. Therefore, like the Bank of Japan in the 1990s, the US Fed is now purchasing financial assets outright, starting with the longer-term Treasury bonds and securities issued by government-sponsored enterprises, such as Fannie Mae and Freddie Mac. The types of securities that can be purchased by central banks can be expanded to include corporate bonds, state and local government bonds or even the sovereign bonds of foreign countries.

Stabilising The Financial System

To stabilize the US financial system, on 14 October 2008, the US Congress authorised the Treasury to establish TARP (Trouble Assets Relief Program Funds) amounting to US$700 billion, The TARP facility is being used to address solvency problems in the banking system and in other financial institutions by injecting capital into them, and by removing toxic assets from their balance sheets. To avoid further erosion in the financial condition of banks, including their Tier 1 or core capital, Securities and Exchange Commissions around the world have banned short selling of shares of financial institutions and their clients.

Panic withdrawals of deposits from banking system have been stopped by restoring trust and confidence through broadening the coverage and increasing the size of the guaranteed liabilities of insured institutions by deposit insurance companies. Similar blanket guarantees on bank deposits have been introduced all around the world, including this region. To avoid disruption of foreign trade and investment, some emerging economies, such as South Korea, have provided guarantees for foreign-currency borrowings by their private sectors.

The process of bank consolidation in the US, backed by government, started with the provision of emergency financing by the New York Fed to JP Morgan on 14 March 2007, to enable it to take over the financially distressed Bear Stearns, a large and well-regarded investment bank. The availability of TARP funds has accelerated the process of consolidation through mergers and the conversion of many non-bank financial institutions (NBFI) into regular commercial banks. In return, for a closer scrutiny by the central bank, the commercial banks are entitled to receive liquidity support from the bankers' bank.

Through capital injections, loans and guarantees on commercial debts, the US government has effectively nationalised the financial sector and automobile industry in the United States. The Treasury allocated US$250 billion of the TARP funds for recapitalising large banks (US$125 billion each for 9 large banks), smaller local banks, savings associations, and certain bank and savings and loan holding companies. The large banks that have received TARP funds include JP Morgan, Citigroup and Wells Fargo.

A number of small and financially weaker institutions have been taken over by financially stronger ones. The NBFIs in the US that have been approved to become regular commercial banks include industrial loan companies, such as GMAC, IB Finance Holding Companies, CIT Group, the American Express Company and the American Express Travel Related Service Company (AMEX). Owned by General Motors, GMAC has been a primary source of financing to customers and dealerships seeking to purchase and lease GM vehicles. AMEX provides charge and credit payment-card products and travel related services all over the world.

One hundred billion of the TARP funds has been used to purchase direct obligations of three housing related government sponsored enterprises, namely, Fannie Mae, Freddie Mac and the Federal Home Loan Bank, while US$500 billion has been allocated for the purchase of mortgages guaranteed by these quasi governmental companies. The American International Group (AIG), a large insurance company, received a capital injection of US$40 billion in TARP funds. The financially distressed car makers, General Motors, Ford, and Chrysler, are seeking US$25 billion in financial support from the TARP funds.

The Eurozone, with one currency for 15 sovereign member countries, possesses neither a single supervisory authority nor integrated supervision of Euro area banks with lender of last resort facilities to help prevent a recurrence of the present financial turmoil. Eurozone does not have a concerted plan to deal with the failure of systematically important cross-border European banks, either. Each member country supervises the financial institutions within its own jurisdiction, and acts individually to resolve the liquidity and solvency problems of its own home banks. After the collapse of the Icelandic banks, it became clear that both supervision and support on the part of the Icelandic central bank were insubstantial.

To protect their financial systems, the authorities around the world have developed programs similar to the US recapitalisation bailout program. There are three ways in which government has injected capital and removed toxic assets from bank balance sheets. First, the public sector directly purchases the toxic assets from the financially distressed banks. This is the original plan of the US Treasury. Second, the government provides asset guarantees in return for warrants, the way the US Treasury rescued Citigroup. The third way is to establish bad banks to purchase toxic banks from the financially troubled financial institutions. It turns out that it is not easy to buy toxic assets due to the difficulty in assessing their price in a time of crisis in order to insulate taxpayers from losses.

Fiscal Policy

Fiscal policy, both tax cuts and expansion of government spending, has been the most powerful policy instrument to expand aggregate demand after the credit crunch made monetary policy ineffective in expanding consumption and investment expenditure, and hence increasing economic growth. Fiscal stimulus is expected to cause an incremental increase in aggregate demand. This only happens, however, if the recipients, both households and businesses, are willing to spend more money than they would otherwise have spent. Because of this requirement, the structure of a fiscal stimulus is very important, as it does not only impact the aggregate demand, but also income distribution.

Another important element of fiscal policy is the timing of both tax cuts and expenditure expansions. Fiscal policy that will cause unprecedented budget deficit is only, however, a temporary initiative and cannot be continuously relied upon as it can negatively affect a country's solvency. Government borrowing from the domestic financial market to finance budget deficit raises interest rates and crowds out private investment. The slowdown in private sector investment reduces productivity and the standard of living. The increase in public borrowing from domestic and foreign financial markets increases government debt. Servicing domestic and foreign debt requires higher future taxes to pay both the principal as well as the interest on that debt. The resulting higher tax rates distort economic incentives. Servicing external debt requires an increase in export revenues and causes transfer problem that weaken economic performance.

The large number of issuers of sovereign bonds for financing fiscal stimulus increases competition for a limited pool of international savings that will increase interest rates in international markets. This in turn will reduce access of both the corporate sector and the governments of many countries to the international credit markets. In January 2009, Standard&Poor downgraded sovereign credit rating and long-term sovereign debt of many countries, including Greece, Spain and Portugal because of their deteriorating public finances and exports. During the time of crisis, government tax revenue is declining and government social spending is increasing. A combination of the shrinking supply of funds, rising credit risk, the increase in interest rate, and the downgrading of sovereign credit rating as well as bonds of the emerging economies has ended the easy credit and has given the way to a withdrawal of funds from less advanced economies. Political pressures, government regulation and 'moral suasions' are increasingly putting pressures on financial institutions to give priority to home markets.

The state support of financial institutions in many countries, for example, is increasingly accompanied by explicit obligations to lend to support businesses and jobs at home, not abroad. Banks themselves are retreating from overseas markets to minimize credit risks. Credit risk in home markets is perceived much easier to manage than in overseas markets. In his remark recently at the World Economic

Forum in Davos, Lord Adair Turner, the Chairman of Britain's Financial Services Authority, calls the reflux of capital from foreign markets to home ones as "the risk of new mercantilism" centred on credit availability.

At a November summit in Washington D.C., the G20 recognised the need to coordinate sporadic fiscal policy initiatives to overcome the present global crisis. In reality, however, there has been no effective global fiscal policy response to magnify the combined impacts of coordinated national stimuli. The Eurozone also lacks a central fiscal authority. Fiscal policy coordination in the EU is dependent on the government budget deficit rule (not higher than 3% of the GDP) and debt rule (no more than 60% of the GDP), as set out in the Maastricht stability pact of 1991. The EU (European Union) proposed a Euro 200 billion economic stimulus program on 27 November 2008, which amounted to 1.5% of the EU's GDP. The funding (Euro 170 billion) is expected to mainly come from contributions by the EU's 27 member states in the form of tax cuts and expansion of infrastructure expenditures. Some member states, however, are unwilling to make large commitments.

Table 1 shows fiscal stimulus packages in leading economies as of the first week of December 2008. Fiscal stimulus in Germany, the leading economy in the Eurozone, for example, only amounted to Euro 31 billion, or 1.25% of its annual GDP, most of which was to be spent on infrastructure investment. The stimulus packages in the United States and Taiwan range between 3 percent and 5% of GDP, while the figure in Japan is 2%. On 22 January 2009, Singapore announced a larger fiscal stimulus totalling SIN$20.5 billion equivalent to 8% of GDP, partly financed by withdrawing SIN$4.9 billion from its fast external reserves.

The objectives of the Singaporean stimulus program are to save jobs, to help viable companies to stay afloat, to provide support to low income groups, and to finance long-term sustainable projects such as health, education, green transport and energy. On 28 January 2009, the US House of Representatives passed a $787.2 billion economic stimulus plan containing emergency spending and tax cuts as proposed by the new administration of President Barack Obama came to power on 20 January 2009.

Table 1. Fiscal Stimuli for FY 2009 in Leading Countries

Country	Size of Stimulus		The Use of Stimulus
	In Nominal Terms	As % GDP	
1. The United States	US$500 billion to US$700 billion	3% to 5%	Income tax cuts for consumers and temporary increases in food stamp payments for lower income groups. US$136 billion in infrastructure projects that are "ready to go". Investments in renewable energy projects and other "green jobs" initiatives.
2. Germany	31 billion	1.25%	15 billion Euros for new lending to companies through state-owned bank KfW. New government investments and contracts in infrastructure and transport.
3. Great Britain	£20 billion	1.2%	Tax cuts and £3 billion of capital spending. Cut in VAT (sales tax) to 15% from 17.5%. Tax repayments where business can offset current losses against past profits, and tax exemptions for companies' foreign dividends.
4. France	26 billion	1.3%	10.5 billion Euros on infrastructure, research and development, and financing for local authorities. Aid for the auto industry with a 1,000-euro subsidy for car buyers to scrap their old vehicles and buy new, more environmental friendly models. 11.4 billion euros to help companies by early reimbursement of state debt due them, spending to create or safeguard jobs. 1.8 billion euros for more zero-interest housing loans and public housing schemes
5. Russia	US$20 billion	1.5%	Cut in tax on profits to 20% from 24% and a new depreciation mechanism that will allow firms to reduce the profit tax further. Billions of dollars of soft funding from state-run banks to support industry.
6. Japan	5 trillion Yen	2%	2 trillion Yen in direct cash payouts to families, tax breaks on mortgages, bank rescue scheme involving 2 trillion yen in public fund injections, and tax relief for small firms.
7. China	4 trillion RMB	16%	1.8 trillion RMB on large-scale infrastructure projects such as railways, roads, and airports. 1 trillion RMB to rebuild areas ravaged by May's Sichuan earthquake. Lower-income housing, large-scale environmental cleanup, rural infrastructure, and industrial restructuring.
8. Australia	A$15.4 billion	1.2%	Spending on hospitals and schools to generate 133,000 jobs

9. South Korea	14 trillion Won	1.5%	Wide range of tax cuts including corporate tax and income tax over five years. 8 trillion won to help the construction industry including buying firms' unused land and unsold new homes.
10. Taiwan	NT$483 billion	3.5%	A NT$82 billion shopping voucher handout-or NT$3,600 for every one of its 23 million citizens. NT$58.3 billion in infrastructure spending to create 100,000 jobs by mid-2009. Subsidies to low-income households and tax-cuts for private investment.
11. Singapore	S$2.9 billion	1.2%	Enhancing existing business financing schemes by giving bigger loans, raising government risk sharing of loan defaults and extending schemes to all local enterprises. S$600 million packages over two years to enhance job-training programmes and increase training subsidies for workers.
12. Hong Kong	HK$19.3 billion	1.2%	66 small-scale projects to create over 12,000 jobs. Construction brought forward to 2009 from 2010 on a mega bridge to link Hong Kong, Zhuhai, and Macau.
13. Malaysia	RM7 billion	1.1%	RM5 billion for construction and upgrading of infrastructure such as schools, high-speed broadband, hospitals, roads, low-cost housing, and government buildings. Fuel subsidies and a cut in employees' pension fund contribution to 8% from 11%. RM600 million for worker training programmes.

Source: *The Straits Times*, Saturday, 6 December 2008, A12-A18.

China is one of the countries in this region that has had both budget and current account surpluses for many years. The country has also accumulated nearly $2 trillion in foreign exchange reserves. All this allows China to step up domestic spending to fill the gap left by a major drop in exports due to recession in its main export markets, namely the US, Europe and Japan. Cash rebates for low income groups will likely be more effective in promoting expansion of aggregate demand in China than tax cuts. Tax rebates for middle and high income groups in thrifty China are unlikely to work as people will simply save the money. This is because household tax is either non-existent or very light in China.

The recently announced fiscal stimulus package in China, amounting to four trillion RMB ($586 billion), or 16% of the GDP, is unlikely to be enough to maintain the minimum economic growth of 8% in order to absorb new entrants to the labor force. The structure of the stimulus package will not encourage domestic spending as it focuses on modernising railways, building roads and airports, rebuilding the rural areas devastated by the Sichuan earthquake in May last year, and other infrastructure projects that may be useful to support short-term economic growth, but not long-term productivity. Only about 1% of the fiscal stimulus will be spent on expanding social services to cope with the economic downturn by easing the burden on families as regards education, healthcare, old age and unemployment.

Australia, Japan, South Korea and Taiwan can also afford to expand domestic aggregate demand to ease the global crisis. Benefiting from the commodities boom, Australia has enjoyed budget surpluses and ballooning external reserves since the mid-1990s. Japan, while it has large external reserves, also has large government debt. South Korea and Taiwan also have financial resources. Like China's exports, the exports of sophisticated manufacturing products from Japan, South Korea and Taiwan are also suffering from falling demand in their traditional markets in the US and Europe.

South Korea has announced a 33 trillion won fiscal stimulus in its 2009 budget. Australia unveiled a large stimulus plan on 3 February 2009 totalling 41.5 billion Australian dollars or US$26.19 billion over the next four years in combination of cash handouts, infrastructure spending and tax breaks. Fiscal stimulus in Taiwan includes shopping vouchers worth NT$3,600 ($107) per person. Low income workers, farmers and students in Australia are given cash hand outs A$1,000 each to spend.

Weak fiscal balance and small amount of fiscal surplus and external reserves limit the capability of developing and emerging economies to introduce fiscal stimulus. Raising funds through selling sovereign bonds is difficult while raising tax revenue is likely impossible due to the economic recession and weak tax administration. As evident in Indonesia's experience in the early sixties, printing money for financing expanding government spending will cause a high inflation rate with disastrous consequences. At the same time, widespread

tax evasion makes tax break a useless policy to stimulate economic growth.

RECOMMENDATIONS FOR REGIONAL POLICY COORDINATION AND COOPERATION

The economies of Asia-Pacific are sitting on huge foreign exchange reserves, which are mainly invested in US dollar denominated assets, particularly US Treasury papers. As of November 2008, six of the top ten countries in terms of foreign exchange reserves in this region were-- China ($1,885 billion), Japan ($977 billion), Taiwan ($292 billion), South Korea ($212 billion), Singapore ($162 billion) and Hong Kong ($155 billion). These exclude Russia ($441 billion), which is a member of APEC, and India ($239 billion) in South Asia. Learning from the experience of the Asian financial crisis of 1997-98, the countries of the region have long been accumulating foreign currency as a shield to ward off speculators. This region has generated savings both from exports and the boom in commodity prices. The money, however, is unevenly distributed.

Well endowed with the huge amounts of foreign exchange reserves, the Asia-Pacific economies can forge five forms of economic cooperation and coordination to achieve common goals. First, to stimulate national economies through the expansion of both public sector spending and private consumption expenditures. As pointed out earlier, in the long-term, the export-led development strategy of many Asia-Pacific economies can gradually be replaced by domestic oriented growth strategy particularly in the countries with potentially large domestic demand. The usefulness of tax rebates is limited in the emerging economies of this region due to the people's thriftiness, the low number of effective taxpayers, and rampant tax evasion and avoidance. Coordinated and well-structured efforts in Asia Pacific are capable of amplifying sporadic national programs for mutual benefit. Part of the economic stimulus should be to build modern infrastructure that is so badly needed for further growth in this region.

The program to stimulate national economies with large external reserves includes expansion and the strengthening of domestic demand by correcting the government policies that suppressed both the share of wage income relative to GDP as well as domestic

household consumption. To lift up the share of wage income relative to the GDP, there is a need to correct government policies that are biased towards manufacturing industries and, particularly in favour of capital-intensive industries. The program to ease the burden of families in social service expenditures such as health, education, old age and unemployment benefits, also requires the modernisation of the financial system such as social security, health insurance and pension funds. Policies that favour capital intensive manufacturing and export oriented development program include subsidies and tax breaks, interest rates and exchange rate policies.

Second, to use the huge external reserves of this region for expanding the bilateral currency swap arrangements under the Chiang Mai Initiatives (CMI) so as to facilitate intra regional private sector investment and trade in the Asia-Pacific. The CMI can be expanded by increasing the number of country participants, increasing the amount of the swaps, and by making the use of swap facilities more flexible. Ideally, the funds should be multilaterally pooled as a kind of collective action to help neighbours in meeting their liquidity needs. These pooled financial resources could be used to directly lend to member countries in need.

The facility could also be used as credit enhancements or guarantees to facilitate member countries in borrowing in the regional and international financial markets to overcome the growing financial mercantilism. The recent trilateral summit between Japan, China and Korea that provided a currency swap for Korea represents a good starting point for reforming the CMI. This currency swap facility, and a currency swap facility provided by the US Fed, will allow Korea to address the urgent issue of capital flight because of the high dependency of both its private sector and banking system on foreign funding. To operate a multilateral pooling of exchange reserves, the Asia-Pacific region needs to establish macroeconomic surveillance. At present, this region relies on inputs from the Asian Development Bank, the only regional financial institution in the Asia-Pacific.

Third, to provide financial resources to emerging countries in this region, in order to limit the adverse effects of global crisis on their economic growth and employment. This can be done through bilateral mechanism and/or through multilateral financial institutions, such

as the ADB, IMF and the World Bank. The recent pledge by Prime Minister Taro Aso of Japan at the World Economic Forum in Davos to provide aid amounted to 1.5 trillion yen (US$17 billion) to emerging economies in Asia is a welcome initiative. The financial assistance would be used for building infrastructure projects in the recipient countries.

Aside from increasing the capacity of regional and international financial institution to lend, the principles to borrow from these institutions need to be changed by relaxing conditionality for those countries that are facing difficulties mainly because external adverse effects and not because of their fault. Stringent conditionality should be applied to those countries with policy inadequacies.

Fourth, to strengthen regional cooperation to avert the threat of financial mercantilism. Closer regional economic cooperation on financial issues can be started by forging closer cooperation of bank and financial market regulators in sharing information on the management of liquidity by banks, total leverage and assessment of risk-weighted assets. Because of the oversensitivity of sovereignty, diversity in the levels of economic development and social system in this region, creation of a single supervisor of cross border banks and financial markets is not feasible at the present time.

Fifth, policy coordination should also be strengthened to ward off the return of trade mercantilism that would only serve to deepen the recession. This requires close policy coordination on exchange rate management, the environment, state aid, agriculture, trade and investment.

INDONESIA'S TRADE POLICY CHALLENGES

M. Chatib Basri and *Hal Hill*

INTRODUCTION

Indonesia is the fourth most populous country in the world, and the largest economy in Southeast Asia. Its economic performance has been highly variable. It was dubbed the 'chronic economic dropout' by the major development economics textbook of the 1960s (by Benjamin Higgins), in recognition of the fact that income per capita at that time was lower than that of 50 years earlier. A quarter of a century later the World Bank classified it as one of the seven East Asian 'miracle economies', reflecting the rapid growth it had achieved since 1967. In 1997-98 it was deeply affected by the Asian economic crisis, and the resultant domestic political turmoil. In 1998 the economy contracted by over 13%. The country suddenly lurched from an authoritarian, growth-oriented regime to a democratic state with under-developed institutions, and a greatly weakened national government wrestling with the fiscal, financial and social aftermath of the crisis.

The trade policy pendulum has also swung from closed to open. By the mid 1960s, the country had formally disengaged from the international economy, including most international organisations,

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and virtually all foreign property had been nationalised. From 1967, however, the new Soeharto regime decisively opened up the economy to international commerce. Serious protectionist pressures emerged in the 1970s but for most of this period, and especially since the mid 1980s, the economy has remained broadly open.

Against such an unusual backdrop, this paper examines the authoritative 2007 World Trade Organization review of Indonesian trade policy (WTO 2007). It provides a brief overview of macroeconomic outcomes and trade policy, extending the period of coverage of the WTO report to 2007. It also examines Indonesian trade policy, both in terms of the structure of formal trade policymaking and the outcomes. The paper is ended with a critique of the WTO report, briefly introducing several policy issues that were somewhat overlooked or perhaps regarded as too sensitive for inclusion in the report.

The main theme of the paper, and implicitly that of the WTO report, is that Indonesia is a largely open economy, but that this openness on occasion remains precarious. There are both political economy, rent-seeking forces opposed to the current openness and, perhaps more important, much of the country's influential public opinion is skeptical of the merits of an open economy and deeper global commercial integration. Nor is there a deeply institutionalised support for openness in the country's bureaucracy and polity. Seen from this perspective, a key question to answer is why the country has remained open, particularly since the devastating crisis of 1997-98.

THE INDONESIAN ECONOMY: RECENT DEVELOPMENTS

The Indonesian economy has now largely recovered from the 1997-98 economic crisis, although it is still growing more slowly than during the period 1968-96. Table 1 summarises recent macroeconomic developments, updating the statistics provided in the WTO report. Several features of the recent macroeconomic record need to be highlighted, as background to the analysis of trade policy.

Table 1: Indonesian Macroeconomic Indicators

	2000	2001	2002	2003	2004	2005	2006	2007
National accounts				*Percentage change*				
Real GDP (2000 prices)	4.9	3.6	4.4	4.7	5	5.7	5.5	6.3
Consumption	2	3.9	4.7	4.6	4.9	4.3	3.9	4.9
Private consumption	5.4	3.5	3.8	3.9	5	4	3.2	5
Government consumption	25	7.6	13	10	4	6.6	9.6	3.9
Gross fixed capital formation	16.7	6.5	4.7	0.6	14.7	10.8	2.9	9.2
Exports of goods and non-factor services	26.5	0.6	-1.2	5.9	13.5	16.4	9.2	8
Imports of goods and non-factor services	25.9	4.2	-4.2	1.6	26.7	17.1	7.6	8.9
Unemployment rate (%)	6.1	8.1	9.1	9.6	9.9	11.2	10.3	9.1
Prices and interest rates				*Per cent*				
Inflation (CPI, percentage change)	9.3	12.6	10	5.2	6.4	17.1	6.6	6.6
Time deposit, in rupiah (from 2007 budget)	11.17	14.52	14.52	9.63	6.2	8.3	10.88	7.6
Time deposit, in US$ (from 2007 budget)			3.65	2.24	1.95	2.62	3.85	
Money credit (end period)			*Percentage change*					
Money supply (M1)[b]	30.1	9.6	8	16.6	13.4	11.1	28.1	27.6
Money supply (M2)[c]	15.6	13..0	4.7	8.1	8.1	16.4	14.9	18.9
Credit to private sector			25.1	22.1	30.4	19.7	14	
Exchange rate								
Rupiah to US$ (annual average)	9595	10400	8,940.00	8,465.00	9,290.00	9,830.00	9,020.00	9158
			Per cent of GDP, unless otherwise indicated					
Government fiscal policy								
Total revenue (excluding grants)	14.8	18.3	16	16.7	17.6	17.7	19.1	18.2*
Tax revenue	8.30	11.30	11.3	11.9	12.2	12.5	12.3	12.9*
Total expenditure	15.9	20.7	17.3	18.5	18.6	18.3	20.1	19.3*
Overall balance (excluding grants)	-1.2%	-2.5%	-2.6%	-1.5%	-1.5%	-0.5%	-1.3%	1.1*
Primary balance	2.4%	2.8%	2.8%	2.4%	1.4%	1.6%	1.3%	1.1*
Public debt	82.8%	71.5%	59.7%	54.4%	51.0%	42.8%	39.0%	30.8%
Saving and investment								
Gross national savings	31.8%	30.0%	25.1%	23.7%	24.9%	27.5%	28.7%	28.7%
Gross domestic investment	19.9%	19.7%	19.4%	19.2%	22.4%	23.6%	24.1%	24.9%
Savings-investment gap	12.0%	10.3%	5.7%	4.6%	2.5%	3.9%	4.6%	3.9%
External sector								
Current account balance	4.8	4.3	3.9	3.4	0.6	0.1	2.6	2.4
Net merchandise trade	15.1	14.1	11.8	10.3	7.8	6.1	8.2	7.6
Value of exports	39.5	35.7	29.6	27	27.6	30.3	28.2	27.3
Value of imports	24.4	21.6	17.8	16.7	19.7	24.2	20	19.7
Services balance	-5.9%	-6.2%	-5.1%	0.0%	-4.2%	-3.2%	-2.7%	-2.7%
Capital/financial account balance	-4.8	-4.7	-0.6	-0.4	0.7	0.1	0.7	0.8
Direct investment	-2.7	-1.9	0.1	-0.3	-0.6	1.8	1.1	0.6
Terms of trade (2000=100)			92.4	94.8	93.3	92.1	93.7	
Merchandise exports (percentage change)			3.1	8.4	10.4	22.9	18.1	
Merchandise imports (percentage change)			2.8	10.9	28	37.2	5.1	
Service exports (percentage change)			21.1	-20.6	127.6	7.3	..	
Service imports (percentage change)			7.3	2.1	19.9	13.8	..	
Foreign exchange reserves (US$ million)	29,394	28,016	32,037.00	36,296.00	36,320.00	34,724.00	42,586.30	56,920
in months of imports			6.8	6.1	5	4.1	5	
in months of imports								
Debt service ratio[d] (end-period)			24.7	25.5	27.1	22.1	25.8	

First, growth has gradually accelerated, from the range 3-5.0% in the early years of this decade, to 5-6.5% since 2004. Initially this growth was consumption-led, as typically occurs after a crisis. Investment has gradually picked up, but it still remains well below that of the pre-crisis period. Net exports grew very strongly in the aftermath of the crisis, but for most of this decade they have not been a major contributor to economic growth. The indifferent export performance is a key feature of recent economic performance, and it has important implications for trade policy, to be discussed below.

Second, there is serious labour market disequilibrium. In spite of the economic recovery, Indonesia's unemployment rate has remained stubbornly high, in the range 9-11% since 2002. This 'jobless growth'[1] has been the result of both the slower overall growth rate, and a less labour-intensive growth path. The latter has arisen principally because of much more interventionist labour market policies, related to minimum wages, severance pay and other conditions. This too has implications for trade policy, since the country's general openness has not delivered on employment growth, as was the case in earlier periods, and therefore the constituency for liberal economic policies is weaker.

Third, macroeconomic management has been reasonably effective. Indonesia has continued a tradition whereby inflation is held in check, but is consistently above its major trading partners and neighbours, typically by around 3-6 percentage points. With a floating exchange rate regime, loosely tied to the US dollar, the result has been a persistent tendency for the real effective exchange rate to appreciate, as discussed below. A major factor contributing to these macroeconomic outcomes has been very prudent fiscal policy, with deficits in the range of 1-2% of GDP in recent years. As a result, public debt as a percentage of GDP has fallen sharply, from 83% in 2000 to 31% in 2007. This is a remarkable achievement for a country so severely affected by a deep crisis just a decade ago.

Fourth, the country's balance of payments position remains comfortable. As often occurs after a crisis, Indonesia has been running

[1] See Manning, C. 2008. "SBY's Dilemma: Jobless Growth?" Working Paper, Australian National University, Canberra.

a current account surplus. On the current account, there is an export response to the exchange rate depreciation, while imports slow as a result of this expenditure switching effect and also the slower economic growth. On the capital account, foreigners are more reluctant to lend to the country. Combined with renewed capital inflows since 2004, these have resulted in a large increase in foreign exchange reserves, which have almost doubled over the period 2000-07. The external debt-service ratio is also comfortable. Perhaps this build up in reserves is excessive, but it reflects in part the strong aversion on the part of policy makers to a repeat of the 1997-98 economic crisis.

Fifth, as the WTO report notes, alongside these mostly sound macroeconomic outcomes is a microeconomic policy environment that is much less conducive to growth. For example, the 2008 World Bank *Doing Business Survey* ranks Indonesia 123rd out of 175 countries in terms of ease of doing business; it also reports that it takes at least 80 days to register a business. Infrastructure investment is inadequate, particularly in power generation and roads. Most comparative business surveys report high levels of corruption. Moreover, unlike the Soeharto era, this corruption is unpredictable, in the sense that the link between bribery and desired outcomes is uncertain. Inevitably these outcomes reflect the major transitional challenges associated with building the institutions of economic governance on the road to democracy.

The government, whose key economic policy makers are people of great technical proficiency and integrity, is of course aware of these challenges. As the WTO report notes, major investment reform packages were enacted, in 2006 (Presidential Instruction (PD) 3/2006) and 2007 (PD 6/2007), as well as a new Investment Law in 2007 (Law 25/2007). These initiatives are comprehensive, covering customs and excise, taxation, labour, infrastructure, financial sector development, foreign investment, small-medium enterprises, and much else. They have also been accompanied by detailed time lines for implementation. It is too early to evaluate their impact, and in some sensitive areas such as labour market policy the government has backtracked. But in principle the measures are highly desirable.

Since the WTO report was completed, the major global macroeconomic developments have been the sharp rise in global fuel

and food prices, and serious financial stresses originating from the US 'sub-prime' market. Of these, the greatest domestic impact to date has been the increased fuel prices. Indonesia is generally close to being self-sufficient in food, typically importing 2-4% of consumption needs (although there are of course major distributional consequences of the increased food prices). Moreover, thus far the domestic financial sector has been little affected by international financial stresses, a reflection of the fact that it is less connected to global financial markets and the country is running a current account surplus.

The problem in the case of fuel prices is that, owing to political sensitivities, the government has been reluctant to allow domestic prices to follow international trends. As a result, Indonesia has among the lowest petroleum prices in the world, at about 60 cents per litre. However, this has been achieved at great cost: currently the fuel subsidies cost the government about US$20 billion, equivalent to more than 5% of GDP, and exceeding the government's entire social and capital works expenditure. The subsidies make little sense on both efficiency and equity grounds. Oil consumption is growing rapidly while production is declining, and is now one-third lower than it was in 2000.

On the equity impacts, it is estimated that the top 10% of households receive 45% of the subsidy while the bottom 10% receive just 1%.[2] In addition, as the world's third largest emitter of carbon dioxide (principally owing to rapid deforestation), the subsidies also complicate the country's international negotiating position on climate change, a not inconsequential consideration given that the country hosted the December 2007 global environment summit. Thus far the government has made relatively minor adjustments to domestic fuel prices, accompanied by compensatory packages for the poor.

The WTO report does not discuss developments in Indonesia's terms of trade and its exchange rate, and the implications for the trade regime. Indonesia has continued to enjoy a substantial windfall gain from high commodity prices. The country is a net energy exporter (though a net oil importer). It is also the world's largest exporter

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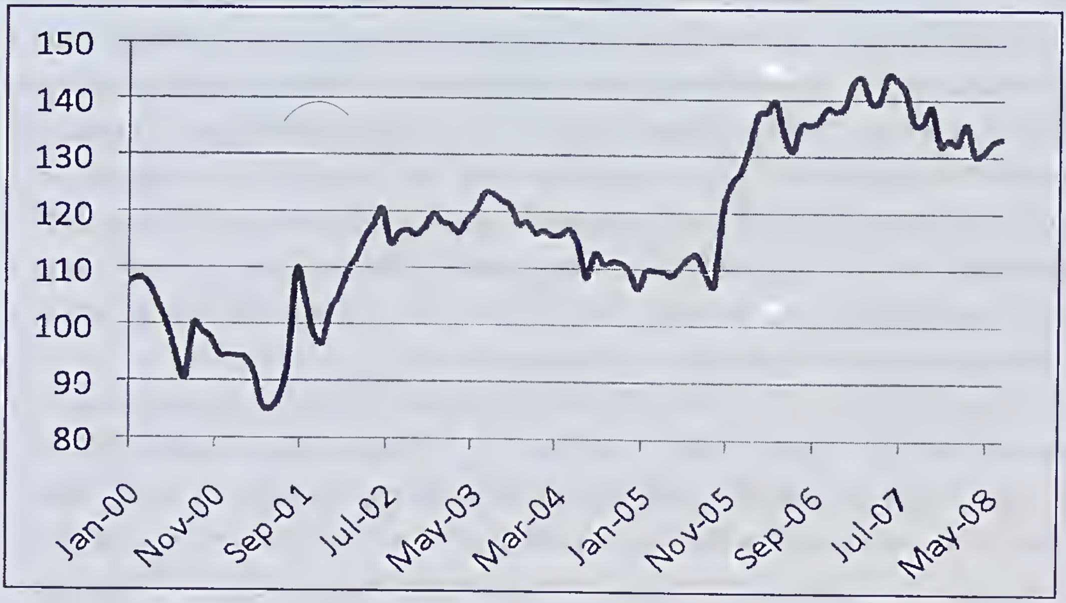
[2] Bulman, T., W. Fengler, and M. Ikhsan. 2008. "Indonesia's Oil Opportunity." *Far Eastern Economic Review* 171 (5): 14-18.

of palm oil, and a significant exporter of a wide range of minerals, including gold, copper and nickel. The prices of all these commodities have been at near record levels in 2007 and 2008.

These effects have been felt particularly in the resource-rich regions off Java, as indicated by the strong growth in credit and wages. But they also of course have economy-wide effects. Indonesia's real effective exchange rate (REER) has appreciated significantly since 2001, by almost 50% (Figure 1). This has occurred mainly as a result of an inflation rate consistently higher than that of major trading partners, as well as a slight nominal appreciation. Increased capital inflows following the restoration of investor confidence over this period have also exerted upward pressure on the exchange rate.

Figure 1. Real Effective Exchange Rate (REER) from Jan 2000-May 2008



The relationship between the exchange rate and the trade regime has been well established in the literature.[3] Earlier work by the authors demonstrated this proposition empirically for Indonesia in the period through to the mid 1990s.[4] An appreciation of the REER lowers the

[3] See Corden, W.M. 1997. *Trade Policy and Economic Welfare*. Oxford: Oxford University Press.

[4] Basri, M.C. 2001. The Political Economy of Manufacturing Protection in Indonesia, 1975-1995. Unpublished doctoral dissertation, Australian National University, Canberra. See also Basri, M.C. and H. Hill. 2004. "Ideas, Interests and Oil Prices: the Political Economy of Trade Reform during Soeharto's Indonesia."*The World Economy*, 27 (5): 633-656.

price of tradables compared to non-tradables, other things being equal, and therefore increases the competitive pressures on the former. These pressures may be ameliorated by increased productivity, labour market adjustments, the provision of more efficient inputs (e.g, in infrastructure), or similar REER trends in major export competitors. In Indonesia, none of these domestic factors has been in operation over this period, and thus the profitability of tradable goods activities has declined. In addition, margins have been squeezed by the continued strong export performance of major Asian producers, particularly China.

TRADE POLICY: PRINCIPLES AND PRACTICE

Indonesian trade policy over the past two decades has been dominated by two key considerations. The first, and most important, has been a preference for unilateral trade reform, in the context of a preference for a multilateral system of trade negotiations and liberalisation. In particular, the trade liberalisations of the mid and late 1980s were significant and effective. For example, Fane and Condon[5] showed that the weighted average rate of effective protection for manufacturing (excluding the special case of oil and gas processing) declined from 59% to 16% over the period 1987-95 (with most of the gains concentrated in the first half of the period), while the dispersion (standard deviation) fell from 102 to 39.

The coverage of NTBs fell even faster: the percentage of non-oil manufacturing value added affected by NTBs declined from 77% to 17%. Indonesia's multilateral credentials are further illustrated by the fact that, unlike several of its Southeast Asian neighbours, it did not sign onto a bilateral preferential trade agreement (PTA) until 2008, when it signed an Economic Partnership Agreement with Japan, where arguably the principal concession offered to Indonesia is a modest expansion in employment opportunities for its semi-skilled workers.

The second general observation concerns Indonesia's membership of the Association of Southeast Asian Nations (ASEAN) since the

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[5] Fane, G. and T. Condon. 1996. "Trade Reform in Indonesia, 1987-1995." *Bulletin of Indonesian Economic Studies*, 32 (3).

body's establishment in 1967. ASEAN is the developing world's most durable and successful regional grouping. Although initially established with the intention of promoting peace and cooperation in a region then subject to considerable conflict and political uncertainty, over time several economic initiatives have become increasingly important. In 1992, an ASEAN Free Trade Area was enacted, with various targets for the unhindered flow of goods within the region, leading eventually to the possibility of some sort of economic union. Although ASEAN still falls well short of the textbook model of such a union[6], over time its economic cooperation measures have been intensified, leading to the 2007 announcement of a proposed Asian Economic Community.[7]

In this context, it is important to recognise a key feature of ASEAN not widely understood beyond the region (including in the WTO report). This is that, while in principle the AFTA appears to be a preferential arrangement, in practice its discriminatory elements are relatively minor. This is because most of the concessions offered as part of the scheme have been multilateralised. In turn, two main factors explain this outcome. First, about 70% of intra-ASEAN trade is through, to or with zero-tariff Singapore. Second, protection in the region continues to decline anyway, and hence the margin of preference offered by AFTA is falling. It is estimated that over 90% of trade within ASEAN does not avail of these preferences, owing to their limited value, in addition to the bureaucratic complexity of availing of such concessions.

Table 2, reproduced from WTO, summarises Indonesia's tariff structure over the period 2002-06. Several features warrant emphasis. First, tariffs are the main instrument of trade policy, but they account for only about 4% of total government revenue. Owing to the introduction of a reasonably effective value added tax in the 1980s, revenue considerations now play a minor role in trade policy, thus freeing policy makers from a traditional constraint governing trade policy. Second, tariffs are generally quite low: more than 75%

[6] Lloyd, P. 2005, "What is a Single Market? An Application to the Case of ASEAN." *ASEAN Economic Bulletin*, 22 (3): 251-265.

[7] See Hew, D. Ed. .2007. *Brick by Brick: The Building of an ASEAN Economic Community*. Singapore: Institute of Southeast Asian Studies.

of tariffs fall within the range 0-10%. Third, over 93% of tariff lines are bound, but at a high average of 37.5%. Thus tariff bindings, and hence indirectly any concessions as part of any WTO negotiations, are largely irrelevant. The biggest gap between applied and bound rates is in agriculture, and this is also the sector where the most serious NTBs are found (see below). Fourth, over 99% of applied tariffs are ad valorem, which contributes to their transparency. Nevertheless, the structure of tariffs remains complex in some instances, as there are 16 ad valorem rates and three specific rates. There is also some tariff escalation by degree of processing, in practice designed to support some heavy industry sectors, principally those that are state-owned.

Table 2. Structure of Indonesia's MFN tariff, 2002-06 (in percentage)3

	2002	2003	2004	2005	2006	Final bound[a]
1. Bound tariff lines (% of all tariff lines)	..	..	..	..	..	93.2
2. Simple average applied rate	7.2	7.2	9.9	9.9	9.5	37.5
Agricultural products (HS01-24)	8.6	8.6	11.6	11.8	11.4	47.3
Industrial products (HS25-97)	7.0	7.0	9.6	9.6	9.2	35.8
WTO agricultural products	8.6	8.6	12.1	12.2	11.8	47.7
WTO non-agricultural products	7.0	7.0	9.6	9.6	9.2	35.8
Textiles and clothing	10.5	10.5	10.8	10.8	10.9	29.3
3. Domestic tariff "peaks" (% of all tariff lines)[b]	1.6	1.6	5.0	5.0	5.1	0.5
4. International tariff "peaks" (% of all tariff lines)[c]	3.6	3.6	10.7	10.4	10.6	90.7
5. Overall standard deviation of tariff rates	11.2	11.2	15.4	15.4	13.7	12.7

.. Not available.

a Based on 1998 tariff schedule in HS96 nomenclature. Calculations are based on 6,893 bound tariff lines (representing 93.2% of total lines), of which 6,717 (93.2%) are fully bound and 176 (2.4%) are partially bound. Implementation of the U.R. was achieved in 2005.

b Domestic tariff peaks are defined as those exceeding three times the overall simple average applied rate.

c International tariff peaks are defined as those exceeding 15%.

d Nuisance rates are those greater than zero, but less than or equal to 2%.

Note: Calculations include AVEs for specific rates provided by the authorities.

.. The 2002 and 2003 tariff schedules are based on 9-digit HS02 nomenclature consisting of 7,532 tariff lines. The 2004, 2005 and 2006 tariff schedules are based on 10-digit HS02 nomenclature consisting of 11,151, 11,159 and 11,161 lines, respectively.

Source: WTO, 2007, Table III.2.

In addition to tariffs, the report discusses other aspects of government policy that affect trade policy. First, government procurement remains an important instrument of industry policy, and over the years the government has employed it, particularly in assigning preferences to enterprises that are owned by indigenous (so-called *'pribumi'*) interests. In fact, Indonesia has yet to sign the WTO Agreement on Government Procurement, thus signaling the government's reluctance to relinquish this industrial policy instrument. Second, Indonesia remains a relatively active user of anti-dumping measures, mainly for base metals and chemicals. Since these are also among the most heavily protected sectors, and mainly state-owned, it is reasonable to infer that this is a de facto trade policy instrument. Third, national standards are generally formulated in accordance with international standards, and the report concludes that SPS regulations are strictly enforced. There have also been periodic attempts to enforce Intellectual Property Rights. Fourth, the report refers to, but does not attempt to systematically measure, NTBs. It notes that there are a considerable number of export restrictions, affecting coffee, textiles, rubber and certain wood products.

There are also measures that restrict or affect trade in certain ways for selected 'sensitive' goods. These include rice, alcoholic beverages, sugar, hot- and cold-rolled iron coil, and steel products. Fifth, the report also notes that domestic prices are affected by other aspects of government policy. Two in particular are mentioned. One is administered prices for petrol, electricity, cement and some transport services. As noted above, domestic petrol prices are well below international levels. Another is an official commitment to competition policy, since the establishment in 1999 of a competition commission, known by its Indonesian acronym KPPU. The report regards this institution as 'significant in improving competition in the economy'. Such a judgement was warranted at the time of writing. However, developments since late 2007 suggest that the KPPU may have become an instrument of political patronage to some extent.

As noted, the report refers to the existence of NTBs, but concludes that they are generally unimportant. This may be so, but it would have been useful if there had been more discussion of them, their likely

incidence, and their political economy. As Basri and Patunru[8] observe, while tariff rates have gone down, or at least been maintained, some NTBs have proliferated since 2000. In agriculture, 'sensitive' products such as rice, cloves, sugar, corn, and soybeans have been subject to special import licensing; in the case of the former three, exclusive import rights have been granted to domestic producers. Indonesia also continues to ban the import of chicken parts, in addition to imposing quantitative restrictions on the import of meat and poultry products. We discuss this further in the next section.

This somewhat discordant approach to trade policy – generally low tariffs combined with ever-present pressure for NTBs—is in part an institutionalised feature of the country's trade policy regime. Specifically, tariff policy is under the control of the Ministry of Finance, which is generally predisposed towards open economic policies. However, line ministries have influence in setting NTBs, in concert with the Ministries of Finance and Trade. While the latter two ministries are run by highly able economists, the Ministries of Agriculture and Industry are avowedly protectionist, and also captured by vested producer interests. Hence trade policy is a continuous battleground, and a change of key ministerial personalities could easily result in a more protectionist trade policy regime.

One consequence of these incomplete reforms in Indonesia is the growing popularity of special export zones, which are supposed to offer simpler administrative procedures and (sometimes) freer trade. Their proliferation in recent years should be interpreted as reflecting the difficulty policy makers have in achieving further first-best, economy-wide liberalisation. The only zone of any significance is that located on the island of Batam, adjacent to Singapore. This zone's modest success derives from the fact that firms within it effectively operate as part of Singapore's custom zone, and thus the regulatory and logistical impediments to their operation are minimised.

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[8] Basri, M.C. and A.A. Patunru. 2007. 'How to Keep Trade Policy Open: the Case of Indonesia', Prepared for conference on "Globalisation, Asian Economic Integration, and National Development Strategies: Challenges to Asia in a Fast-Changing World." August.

The report is evidently too polite to discuss smuggling, both technical and physical. With its 13,000 islands, proximity to the very open economies of Singapore and Malaysia, and a corruption-prone customs service, smuggling has been an ever-present feature of Indonesian commercial life. While accurate estimates are by definition not available, a widely adopted rule of thumb in the business community is that tariffs in excess of 15-20% will attract illegal trade. The country's major decentralisation of 2001, that transferred significant resources to the approximately 510 sub-national governments, has also emboldened certain local authorities in strategic geographical locations (ie, mainly in coastal proximity to Singapore and Malaysia) to in effect establish their own custom agencies, in contravention of national law. Particularly for goods that are easily tradable, this reality effectively constrains the country's trade policy.

ADDITIONAL COMMENTS AND ISSUES

A major political economy question is why Indonesia has stayed largely open over the past decade? Such an outcome may appear surprising, given the importance of the forces in favour of protectionism. At least four such forces may be identified. First, there has been a strong anti-globalisation sentiment in the public policy debates since the economic crisis of 1997-98, triggered in part by the country's perceived unjust treatment at the hands of the IMF and western donors. It is remarkable how little prominence is given to liberal economic policy opinion even in the country's 'quality' media. Second, as noted, the principal source of protectionist pressure now emanates from the agriculture sector, in contrast to earlier periods when manufacturing was the main beneficiary. With democratisation, rural votes matter, and politicians are able to exploit this factor along with appeal to sentimental notions of food self-sufficiency.

Moreover, it is now easier to introduce protection for agriculture than manufactures owing to various loopholes (quarantine, etc) and to the fact that the OECD north is extremely slow to liberalise its own agricultural protection. Third, democracy brings with it the imperative for political party funding, and with it the potential for 'buying votes'. Although much of that funding emanates from non-tradable sectors, particularly construction, in the 2004 general election at least some

of the vote buying was connected to increased protection. Fourth, as noted the country has experienced a mild Dutch disease since 2002, propelled by rising commodity prices. This has resulted in an appreciating currency, and hence increased pressure on profitability in the tradables sector. An additional complication is the more rigid labour market regulatory environment since 2000, which has had the effect of locking in this competitive disadvantage.

The explanation for Indonesia remaining open appears to rest on the following factors. First, in the immediate post-crisis period, the IMF Letter of Intent played a role, and some of the dismantled protection (eg, the notorious national car project and the clove monopoly, both run by one of Soeharto's sons) was popular. Second, the very large depreciation of the Rupiah in 1997-98 provided some exchange rate protection for tradables, even if the effects had washed out by the early 2000's. Moreover, in the earlier period recovery was dependent on the growth of the export sector, which for a period was politically empowered, and of course opposed to protection. Third, finance ministries are typically central to the resolution of a crisis, and these now more powerful agencies are generally more likely to favour lower protection. This has certainly been a factor in Indonesia when, for most of this period, the position was occupied by an economist of high technical competence and integrity. Fourth, the major 1980s liberalisations were still a recent memory at the time of the crisis, for policy-makers and the business community alike, and thus an unwinding of successful reforms was likely to be resisted. Fifth, the global trend towards liberalisation now has strong intellectual appeal, particularly with the example of the increasingly open Asian giants, China and India, and in contrast to the earlier appeal of Northeast Asian-style 'guided', export-oriented, industry policy. Sixth, Indonesia has had an unhappy experience with industry policy. Former technology minister and president, B.J. Habibie, had little to show for the estimated $3 billion allocated to his prestige, high-tech projects over two decades (although in fairness there was a significant training element). Finally, at the margin, Indonesia is a signatory to various regional trade agreements–WTO and AFTA in particular–which provided a mild barrier to increased protectionism.

Second, although NTBs remain contained thus far, there is a constant danger that they will proliferate. The case of rice, the country's most politically sensitive commodity, illustrates this danger. There has been a long history of intervention in the sector (see McCulloch and Timmer 2008), even though domestic prices have generally followed international trends. In the wake of the 1997-98 economic crisis, as part of the IMF LOI, imports were liberalised and the import monopoly of the state food logistics agency, known as Bulog, was removed. However, from 2000 specific tariffs were re-imposed, initially set of Rp430/kg. In 2003, the tariff was increased to Rp750/kg, effectively raising the ad valorem equivalent tariff from 25% to 45%. The policy was further tightened in 2004 when the Minister for Trade and Industry issued a decree that effectively prohibited the import of rice unless explicitly authorised by the Minister. As a result, domestic prices began to exceed international prices by a significant margin, and smuggling ensued. The ban was in principle supposed to be administered on a seasonal basis, and to allow imports during the off-season. However, in practice it amounted to a complete ban, and the policy remained in place until 2006, when it was partially liberalised.

The third issue concerns Indonesia's export performance since 2000, a period of buoyant commodity prices and strong global economic growth. The country's export growth has lagged its neighbours (including even the Philippines), and also that of the pre-crisis period.

Table 3 clearly demonstrates the slowdown in export growth since the 1990s by decomposing the data into price and volume effects with the aid of sectoral deflators. In the pre-crisis period, 1990-96, real exports grew at 12.2% per annum. However, since 1996 real export growth has slowed to less than half that rate, at 4.8%, in spite of the major exchange rate depreciation in the late 1990s. The slowdown in non-oil export growth was even sharper, from 20% to 7.4%. Most important of all, for the key labour-intensive manufactures segment, growth collapsed, from 23.5% to 4.7%. This applied to all major sub-sectors—garments, textiles, footwear (with negative growth), and furniture—suggesting the causes were economy-wide rather than sector-specific. There were some marginally negative price effects for

these commodities over the period 1996-2006, presumably reflecting increased competition from China and other newly emerging exporters, but these effects explain only a small proportion of the declining growth.

Table 3: Indonesia's export growth and price effect

				Constant Prices		Current Prices		Price Effect	
Categories	1990	1996	2006	90-96	96-06	90-96	96-06	90-96	96-06
Oil/Gas	13.1	15.1	9.3	2.4	-4.7	8.4	6.2	6.0	10.9
Agriculture Commodities	3.7	5.4	13.0	6.5	9.1	15.3	8.4	8.8	-0.8
Fish and Shrimp	1.0	1.3	2.1	5.5	4.8	9.7	0.6	4.2	-4.3
Rubber	0.9	1.4	2.3	8.4	5.1	18.7	9.2	10.3	4.0
Palm & Palm Kernel Oil	0.4	0.8	5.1	12.9	20.4	27.4	17.3	14.5	-3.0
Coffe & Cocoa	0.7	0.9	1.3	4.6	4.1	12.9	4.2	8.4	0.1
Minerals	2.1	4.3	10.1	13.0	8.8	19.4	14.0	6.4	5.2
Copper	0.4	1.9	2.5	28.7	3.0	27.8	12.0	-1.0	9.0
Coal	0.1	1.0	5.4	39.0	18.8	37.3	17.2	-1.7	-1.6
Nickel & Tin	0.4	0.5	1.3	6.2	9.1	4.9	14.3	-1.3	5.1
Forestry Products	1.0	5.7	6.6	33.6	1.4	46.2	0.1	12.6	-1.3
Plywood	0.2	3.0	1.4	63.1	-7.4	80.5	-7.9	17.4	-0.5
Paper & Paper Products	0.1	1.4	2.5	48.3	6.2	35.6	10.5	-12.7	4.3
Pulp & Waste Paper	0.1	0.5	1.3	42.1	10.4	33.8	9.1	-8.3	-1.3
Manufactured Products	4.3	17.7	38.4	26.5	8.0	29.5	5.9	3.0	-2.1
Textiles & Footwear	2.2	8.0	12.1	23.6	4.2	23.3	1.6	-0.3	-2.6
Textile Fabric	0.5	1.8	2.5	22.1	3.2	16.2	-1.4	-5.9	-4.7
Textile Fiber & Thread	0.1	0.9	2.3	53.9	9.6	50.4	6.0	-3.5	-3.5
Garments	1.0	3.3	6.0	20.9	6.3	20.5	3.9	-0.4	-2.4
Footwear	0.6	2.0	1.3	23.0	-4.1	30.2	-4.0	7.2	0.0
Electronics & Computers Parts	0.2	3.4	8.6	61.6	9.7	90.2	8.1	28.6	-1.6
Other Manufactured Products	1.9	6.3	17.7	22.2	10.8	27.9	8.6	5.7	-2.3
Chemicals	0.2	1.5	5.4	34.9	13.8	34.8	11.1	-0.1	-2.7
Furniture	0.2	0.8	1.8	22.4	8.5	24.5	5.6	1.0	-2.9
Machinery	0.1	0.4	2.4	41.0	18.3	53.3	15.8	12.3	-2.5
Tires & Rubber Products	0.1	0.2	0.7	26.4	11.6	28.9	11.3	2.5	-0.3
Total Exports	24.2	48.3	77.3	12.2	4.8	16.3	6.7	4.1	1.9
Total Non Oil/Gas	11.1	33.2	68.0	20.0	7.4	26.3	6.8	6.4	-0.6
Labor Intensive Manufactured Exports									
Textiles & Footwear	2.2	8.0	12.1	23.6	4.2	23.3	1.6	-0.3	-2.6
Furniture	0.2	0.8	1.8	22.4	8.5	23.5	5.6	1.0	-2.9
Total Labor Intensive Manufacture	2.5	8.8	13.9	23.5	4.7	23.3	2.1	-0.2	-2.6

Source: Papanek and Basri (forthcoming), using BPS data from Tim Buehrer and the World Bank. *) 2006 estimates

Exports of electronics have also slowed down sharply. This partly reflects the very high growth rates in the earlier period off the small initial base, and also the global slowdown in the industry in the early 2000s. However, Indonesia lags behind its neighbours in this, the most important export sector for developing country manufacturing. For example, the share of electronics parts and components in Indonesia's exports is about 9%, compared to 21% and 36% for Thailand and Malaysia respectively.

These slower growth rates result from the fact that Indonesia has not participated extensively in the rapidly expanding East Asian production and buying networks, especially in the electronics and automotive industries. The key here is for host countries to link to these highly competitive global production factories and networks. For countries to get into the loop they need commercial policy regimes and logistics systems which enable goods (and services) to flow seamlessly across international boundaries. Specifically, this requires open trade and investment regimes, and the removal of other trade frictions, through high quality 'factory to market' logistics and smooth customs procedures.[9]

In these respects, Indonesia lags most of its East Asian neighbours. Foreign direct investment into Indonesia was negative over the period 1998-2004, and the country has always been ambivalent towards majority-owned FDI, the usual practice in these MNE-dominated, vertically integrated production networks. Customs procedures are slower than regional norms, while port productivity and other infrastructure provision are also weaker. Therefore, as with labour-intensive manufactures more generally, the country's slower export growth is primarily associated with problems on the supply-side, with demand-side constraints being generally minor. This indifferent export performance in turn weakens the constituency for a more liberal trade regime.

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[9] See Athukorala, P.-C. 2006. "Post-crisis Export Performance: the Indonesian Experience in Regional Perspective." *Bulletin of Indonesian Economic Studies* 42 (2): 177-211; and Kimura, F. 2006. "International Production and Distribution Networks in East Asia: 18 Facts, Mechanics, and Policy Implications.", *Asian Economic Policy Review* 1: 346-347.

PRIVATISATION POLICY AND ITS IMPLICATIONS: THE CASE OF PT. TELEKOMUNIKASI INDONESIA

Setyanto P. Sentosa

INTRODUCTION

From the early days our founding fathers realised that Indonesia as a collective political entity did not have sufficient investment capacity to build its economy. This idea is embodied in Article 33 paragraph 2 of the 1945 Constitution which states that "resources, which are important to the State and affecting public welfare, are controlled by the State." Explicitly, it states that the Government takes part in economic activity. As long as the substance of the above article remains contained in the 1945 Constitution, Government's involvement (including within State-Owned Enterprises (SOEs) continues to exist.[1]

As one of the backbones of economic activity, SOEs are expected to provide positive contribution to the Government through dividend, tax and creation of job opportunities. Therefore, to make SOEs profitable is in the best interest of the Government, even though in reality many SOEs are unprofitable. The main reason of this loss is wrong management.

In a number of countries (including Indonesia), SOEs are initially created to overcome problems resulting from failure of market me-

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[1] Subiantoro, Heru and Singgih Riphat, "Fiscal Policy: Ideas, Concepts, and Implementation," *Kompas*, 2004

chanism. Market players do not yet have abilities to do business due to lack of capital or competency, or the business sector in which it is operating requires major investments. When private companies are ready to operate in those market sectors, then the management of SOEs should be transferred to private sectors through privatisation program.

The privatisation program should put more emphasis on the benefits for company's management both in the short and long terms. The goals are to create an open and transparent management system, to establish a highly disciplined organisational culture, and also to get a cheaper source of funds for investment to develop the company.

Privatisation program is a policy that has to be executed by the Government who wants to restructure its economy. Through privatisation (especially using Initial Public Offering or IPO), economic growth can be created. An additional capital received by the company can be used to make an added value through the increase of economic activity, which in turn creates a national economic growth. Equity offering should be directed to a number of public investors so that the share ownership is evenly distributed. Hence, public control or check and balance mechanism will take place. However, for vital and strategic companies, an offering to a single majority investor should be avoided as it can create a long term risk.

Even though a number of researchers have revealed success stories of privatisation program, failures occur in several African and Eastern European countries. Kauffman and Siegelbaum observed privatisation policy and corruption in Russia. Government unpreparedness in bridging the transition period from Communism to Liberalism hindered the privatisation process and the improvement of public welfare. Privatisation program in Poland, in several cases, increased the company's risk of bankruptcy after privatisation because the privatisation program was not followed by an improvement in the company's management system.[2] Boubakri and Cosset[3] studied the

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[2] Barthold Albrecht and Marcel Thum, *Privatization, Labour Participation, and the Threat of Bankruptcy: The Case of Poland* (Muenchen: Department of Economics University of Munich, 1994), 1-2.a

[3] Narjess Boubakri,and Jean-Claude Cosset, *Does Privatization Meet The Expectations? Evidence From African Countries*, Plenary on Privatization and Corporate Governance African Economic Research Consortium Biannual Research Workshop Nairobi, Kenya, 1999.

implementation of privatisation program in Africa and Sub-Saharan and highlighted that the failures were mostly caused by excessive government intervention in SOEs' management after privatisation.

The excessive depth of intervention by the governments of several African, Eastern European, and other developing countries is still apparent in SOEs' operations. Furthermore, the governments' unpreparedness to direct macro economic transition and the companies' inability to restructure itself causes privatisation failures in several developing countries. The above-mentioned cases have motivated the researcher to investigate the implications of privatisation policy towards the performance of SOEs in Indonesia, using PT Telkom case as a case study.

PRIVATISATION AND ITS PRACTICES

Historically, the term 'privatisation' originated from the classic economic theory developed by Adam Smith. In "*An Inquiry into the Nature and Causes of the Wealth of Nations*" (1776), Smith stated that an individual's effort to improve its life is when one uses one's own ability freely and powerful, without any help. Such effort not only can bring society towards welfare but also overcome any possible changes of f man-made guidelines as its implementation may create a burden for an individual.

Beesly and Littlefield[4] further defined privatisation as an exchange of company's ownership from government to private sector. It can also be defined as continuous selling of at least 50% of government's shares to private sector. Dunleavy in Bastian[5] explained that privatisation is a permanent transfer of production activity, both goods and services, from SOEs to private sector. This transfer of public service to private sector is to increase resources efficiency.

However, as argued by Savas[6], privatisation is more of a political activity than an economic activity. Therefore, there are four conditions

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[4] M. E. Beesley, and S.C. Littlefield, "The Regulation of Privatized Monopolies in the United Kingdom," *Rand Journal of Economics* 20, no. 459 (1989).

[5] Indra Bastian, *Privatization in Indonesia: Theory and Implementation* (in Indonesian) (Jakarta: Salemba Empat, 2002), 20

[6] E.S. Savas, *Privatization, The Key to Better Government* (New Jersey, USA: Chatam House Publisher Inc. ,1987), 26-27

to be fulfilled in order to carry out privatisation. First, government has to maintain its support for market mechanism, and to secure and to increase the existing supply of goods and services. Second, if government's involvement is still needed, the involvement needs to be reduced and transferred to private sector. Third, there needs to be transparency in government's public spending in order to find an alternative or substitute system. Fourth, the system of competition needs to be implemented and supported by the abolition of government monopoly through deregulation.

Privatisation policy was first carried out in 1961 when Konrad Adenaur (former West Germany's Chancellor) privatised Volkswagen, an automobile company, through the IPO mechanism. With such The West German's Government successfully obtained a capital of DM 1.2 Billion in the process. Their aim was not to increase the state's income, but to distribute public shares ownership. Volkswagen' privatisation increased the number of shareholders from 500,000 to 3 million investors.[7]

Privatisation became more popular in 1979 after the British Government's success to privatise its public sectors. Under the Prime Minister Margaret Thatcher, the British Government privatised the British Telecom in 1984. The Japanese Government also carried out privatisation policy by selling the majority of their shares in NTT (Nippon Telephone and Telegraph) to the public.

In the case of Indonesia, Law number 19/2003 concerning State-Owned Enterprise defines privatisation as "the selling of SOEs' shares either fully or partially to a third party with the aims to increase company's performance and value, to enhance its benefit for the State and society as well as to enlarge public distribution of shares.

Privatisation of Indonesia's SOEs focuses on reducing the burden of public sector, reducing the amount of subsidy, and to gain political popularity. Privatisation process conducted by the Indonesian Government indicates market failure, which is caused by intervention towards privatisation process, and asymmetry market information.

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[7] William L. Megginson,, Robert C. Nash, and Matthias van Randenborgh, "The Financial and Operating Performance of Newly Privatized Firms: An International Empirical Analysis.,"*Journal of Finance* 49. (1994): 406.

COMPANY PERFORMANCE AND PRIVATISATION

Performance is defined as a tool to measure a company's capability in managing both financial and non-financial resources. SOEs' performance relates to public accountability, which includes transparency in resources and financial allocation, as well as *good corporate governance* (GCG). Basic principles of GCG are transparency, independency, and accountability. Implementation of GCG in a corporation is expected to be a standard reference for every company.

Company's performance can be measured using *Balance Scorecard*[8] because of its ability to provide a more comprehensive picture towards the company's performance compared to other conventional measurement methods such as financial ratio, or fundamental and technical analysis. Factors relevant to the company's management, i.e., financial aspect, customer aspect, internal business process, and learning and growth are analyzed in a comprehensive manner and linked to the formulation of company strategy. *Balance Scorecard* can be used to evaluate company's historical performance as well as predicting company's future performance. In developing *balanced scorecard*, one's company management system has to: (1) define its vision, mission, targets, and strategic theme; (2) translate those visions and strategies into four perspectives used in *balanced scorecard* i.e. financial, customer, internal business process, and learning and growth.

Several studies have shown that privatisation can increase SOEs' performance. It can increase performance since it gives incentives towards improvement in management and good corporate governance. After privatisation, SOEs mostly show a significant improvement as reflected by an increase in sales, a more efficient operation, an increase in profitability and capital expenditure, an increase in dividend payment, and a decrease in company's debt. All of these are measured by (1) Return on Sales (ROS), (2) Return on Asset (ROA), (3) Return on Equity (ROE), (4) Real Sales, and (5) Leverage.

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[8] Robert S. Kaplan, and David P. Norton., *Balanced Scorecard: Translating Strategy into Action* (trans.: *Balanced Scorecard: Menerapkan Strategi Menjadi Aksi*) (Jakarta: Erlangga, 2000).

An investigation by Cuervo and Villalonga[9] resulted in a basic model to explain privatisation's impacts towards company's performance. It is stated that privatisation can increase company's performance through organisational changes. There are five propositions used by the above-mentioned scholars to explain their formulated model as follows:

Proposition 1 : Privatisation leads to greater performance increase when the privatised firm's top management team is replaced.

Proposition 2 : The privatised firm's top management team is more likely to be replaced when the new owners are outsiders, when political interference is low, when top managers have not been replaced prior to privatisation and when capital markets play an effective control role.

Proposition 3 : Privatisation prompts the firm to make incentive schemes and control mechanisms more outcome-based and more market-based.

Proposition 4 : The privatised firm's goal and incentive schemes lead to a greater performance increase when there is an intermediate level of ownership concentration and no large shareholder domination and when boards effectively perform their control role.

Proposition 5a: Privatisation prompts a firm to engage in scope-enhancing corporate strategies and in more innovative and less focused business strategies.

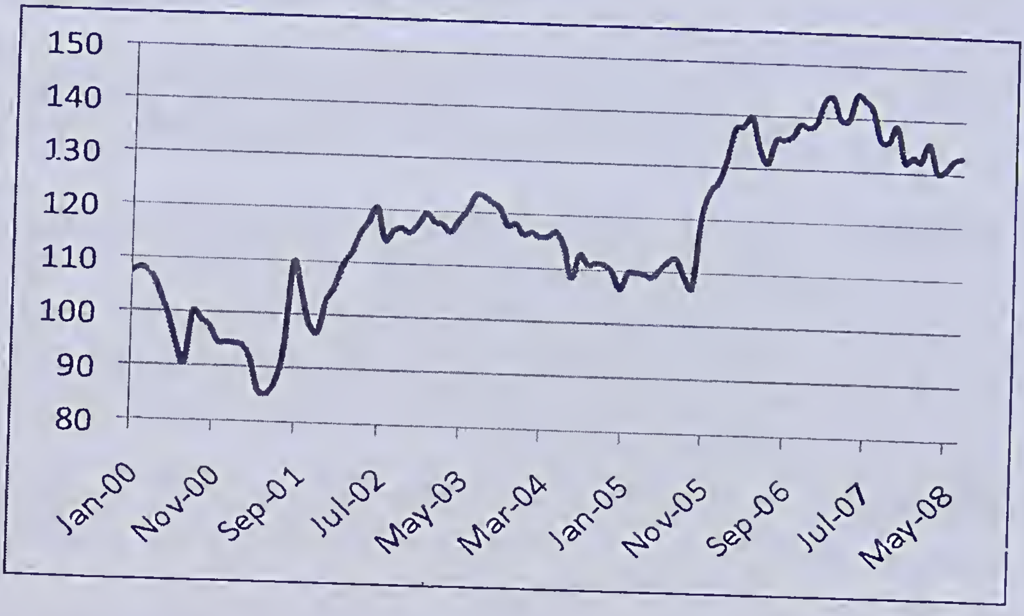
Proposition5b: Privatisation prompts the firm to adopt a more de-centralised organisational structure and a greater customer orientation.

All of the above propositions show that privatisation can become a trigger towards management change and revitalisation; implementation of good corporate governance; change of direction; incentive, control and change in strategy; improvement in structure

[9] Alvaro Cuervo, and Belen Villalonga, "Explaining the Variance in the Performance Effects of Privatization," *The Academy of Management Review* 25, no. 3 (July 2000): 581-590.

and culture of the organisation to achieve a better performance after privatisation. All of which can be explained using the scheme below:

Figure 1. Model of The Impacts of Privatisation Policy towards Company's Performance[10]



Megginson, Nash, and Van Randenborgh conducted a study on companies' performance after privatisation[11]. They compared financial and operational performances of 61 SOEs in 18 countries between 1961–1989, 3 years before and 3 years after privatisation. They compared the averages of financial and operational performance ratios of sample SOEs. The result of examination indicated that the performance of privatised SOEs, economically and statistically, has shown significant increases. These were indicated by increases in sale, operational efficiency, profitability, capital investment expenditure, dividend payment, and decreases in SOEs.

PRIVATISATION IN INDONESIA

Since Indonesia's independence, the role and position of the SOEs have been debated amongst its founding fathers. The focus of this

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[10] Ibid, 584.

[11] Megginson, William L., Robert C. Nash, and Matthias van Randenborgh, "The Financial and Operating Performance of Newly Privatized Firms: An International Empirical Analysis," *Journal of Finance* 49 (1994).

debate was in relation to the policy wording "controlled by the State" (as declared in Article 33, Paragraph 2 of the 1945 Constitution). The first President of Indonesia after the independence, Soekarno interpreted that the State had to take control of major business sectors which could stimulate economic activity due to the weak economic condition after the independence. The Vice President Mohammad Hatta, on the other hand, viewed that the State only needed to control companies which fully affected the basic public needs such as electricity and transportation. His view is in line with the modern economic view whereby the State only needs to provide infrastructure to support development activities.[12]

In the early 1950s, the creation of SOEs was limited to several vital sectors (following Hatta's view). However, in 1958 the Government nationalised almost every sector of the economy (following Soekarno's view). The loss of Masyumi (the Islamic Party) and the Catholic Party in supporting Hatta's view on the Nationalisation Law in the Parliament, resulted in major nationalisation of Dutch companies by the Government.[13]

This major nationalisation can be viewed as *by accident* instead of *by design*.[14] Ironically, most of the nationalised Dutch companies had already transferred its assets to the Netherlands. The Government nationalised numerous dummy companies, which did not give positive contributions towards the economy, even at a later date they became a burden to the Government. To increase SOEs' assets the Government had to allocate resources from national budget, which caused huge increases in the budget.

This condition was worsened by the Presidential Decree 5 July 1959, which stated that from then on Indonesia follows a system of 'guided democracy'. At that time the Government nationalised approximately 600 companies where half of them operated in plantation sector, more than 100 companies operated in mining, and the rest operated

[12] Robert C. Rice, "The Origin of Basic Economic Ideas and their Impact on New Order Policies," *Bulletin of Indonesian Economic. Studies* 19, no. 2 (Agustus 1983): 12.

[13] Ralph Anspach, *Underdevelopment and Economic Nationalism in Southeast Asia* (Ithacha, USA: Cornell University Press, 1969), 179.

[14] Widigdo Sukarman, Liberalization: Study on the Politics and Economics of Banking in the New Order (in Indonesian), Dissertation, unpublished, Department of Social and Politic, Gadjah Mada University, Yogyakarta, 2003, 103.

in trading, banking, insurance, telecommunication, and construction sectors. After re-structurisation in the end of the 'guided democracy' era, the number of SOEs decreased to 233 companies.[15]

The 1997 economic crisis brought consequences for the Government especially in relation to State income and budget. Burden of foreign debt maturity, fragile monetary stability, political instability, and Government policies that protected conglomerates added more pressures to Government's financial condition. SOEs as one of the cash-cows owned by the Government were expected to contribute towards the State income and spending needs either from dividend contribution, tax, or privatisation.

The need to fund State budget heavily influenced future government policy in SOEs management. After the reformation year, SOEs management is guided by the People's Assembly Decree number IV/MPR/1999 regarding: (1) efficient, transparent, and professional management of SOEs; (2) improvement of SOEs that affect public welfare; and (3) encourage SOEs with no direct relation with public welfare to privatise themselves in capital market.

One of the benefits of privatisation is the discipline to implement of good corporate governance principle, which includes transparency, independency, and accountability. These principles are the pre-conditions to increase the performance of SOEs and are the key success factors to create a healthy business environment. Main privatisation methods can be chosen from the following options:

1. Initial Public Offering;
2. Strategic Sales;
3. Liquidation;
4. Employee Buyouts or Management Buyouts;
5. Golden share;
6. Joint operation.

[15] Mardjana I. K., Autonomy and Political Control in Indonesian Public Enterprise A Principal – Agent Approach, *A Thesis for the Degree of Doctor of Philosophy*, Graduate School of Management, Monash University, Melbourne, 1993, 44.

CASE STUDY: PT. TELKOM

Basically PT. Telkom conducted privatisation in order to get cheaper fund for expansion, increasing operational and financial performance, profitability, services, and improving professionalism. The privatisation was based on the following reasons:

1. Change in the world economy required management to adjust company policy in accordance with the change in global business environment;
2. Government funding to finance telecommunication infrastructure was limited;
3. Positive economic growth increased by 6-7% per annum in mid-1990s;
4. Annual increase of foreign debt resulted from the State budget policy based on a balanced budget principle by covering budget deficit with foreign loan or aid;
5. An increase in debt repayment burden which in turn increased matured overseas debt;
6. Self-sufficiency funding (capital structure) through the issue of new stocks to increase equity did not affect company's debt. Therefore, the management had the flexibility to plan and to control company's debt payment.

These external changes were seriously managed by PT. Telkom through initial public offering (IPO) in 1995 in order to gain fresh fund to build telecommunication facility. At the beginning the IPO proposal was rejected by the Government as the latter considered it still had weaknesses. Even the World Bank recommended PT. Telkom to do an IPO in the seventh Five Year Development Plan—in 2005..

Nonetheless PT. Telkom board of directors at that time insisted on the need for investment fund to build telecommunication facilities, which amounted to IDR 25,700 trillion whilst PT. Telkom's debt amounted to IDR 4.9 trillion or an equivalent to USD 2.2 billion. Urgent developments of telecommunication facilities included 4.2 million phone connections (1995-2000), installing fiber optic networks to replace copper cables, building cellular telecommunication facility, satellite procurement, and multimedia networks. Realising the

limitation of the Government funds, PT. Telkom privatisation plan was finally agreed after an examination by a consultant, Price Waterhouse, at the request of the Ministry of Finance.

Prior to IPO execution process, PT. Telkom' management undertook several internal policies, such as fixing up internal affairs especially in operation and employees' disciplines. "Back to basic" program was created with an objective to bring employee back to its professional creed which was supposed to be conducted by every employee in the first place. Furthermore, integrity of every individual was needed to be intensified by reminding employees not to misuse their authority for group or personal interest. Abuse of authority or act of corruption would be penalised.

At that time everything run smoothly and the policies were implemented by employees, which made PT. Telkom known as a clean and transparent SOE. Finally an effort was made to encourage employees to i mprove themselves as challenges and era had changed. This was particularly important in facing competition in the near future. The willingness to change was the basis for PT. Telkom privatisation success.

In order to decide an optimum privatisation scheme, PT. Telkom took the following privatisation steps and procedure:

1. *Initial Public Offering (IPO)*

On 14 November 1995, PT. Telkom became a public company by listing in both domestic market (Jakarta and Surabaya Stock Exchange) and international market (in New York and London Stock Exchange, and equity issuance without listing in Tokyo Stock Exchange).

2. *Strategic Investors*

Besides privatisation through IPO, the company sold equity to strategic investors. In this case, to companies with the same *core business*, expected to increase business scale and to encourage advanced technology transfer. Sale to strategic domestic partner was conducted through B shares allocation towards group of investors in the form of: (1) incentive shares to individual domestic investors, (2) shares to domestic cooperatives; and (3) *Fixed allotment* to institutional investors.

3. *Joint Operation Scheme*

Privatisation was also conducted by involving private sectors in SOEs operation through Joint Operation Scheme. The most common method used in this scheme is *build, operate and transfer* (BOT). On 30 June 1995, PT. Telkom signed a Joint Operation Scheme agreement with five consortiums on telecommunication supply and services in five of the seven telecommunications area. This agreement effectively started on 1 January 1996 as part of concession to private sector to act for and on behalf of PT. Telkom to provide public telecommunication services in each working area. Nevertheless PT. Telkom board of directors excluded operation in several areas out of the Joint Operation Program, such as Jakarta and East Java, since both areas contributed to 63% of PT. Telkom income. Therefore, in any case e.g. if joint operation did not work as expected, both areas would support PT. Telkom' budget operation need.

4. *Employee Stock Ownership Plan (ESOP)*

ESOP gave share ownership rights to its employees through company's incentive program based on performance. In PT. Telkom, employee's share allocation was carried out at the same time of IPO execution. ESOP was included in the group of domestic offering.

5. *Golden Share*

There are two types of shares in PT. Telkom company's statutes i.e., A-series share (preferred stocks) which is single share, and B-series shares (common-stocks) which can be owned by investors. The only owner of A share (known as *'saham dwi-warna'* or 'golden share') is the Government, whereby the Government has exclusive rights such as to decide board of directors and commissioners, and right to veto decision of general shareholders meeting. This A series share is not to be traded in the stock exchange and is permanently owned by the Government.

6. *Golden Hand-Shake Program*

Before privatisation, PT. Telkom had 43,000 employees scattering across the country with as many as 3,000 of them in the head-quarter. This high number of employee made PT. Telkom less attractive

for investors since it gave an impression of a company with low productivity. Considering efficiency and to slim-down the company, early retirement program was conducted and in six month time managed to entice 5,000 employees to voluntary early retirement with a total cost of IDR 300 billion. After the program, the number of PT. Telkom employees was reduced to 38,000 people in which 750 of them in the head-quarter.

7. *Organisational Restructuring*

As an organisation, PT. Telkom serves the whole Indonesian archipelago whereby the central office oversees 12 telecommunication business areas (known as Witel) and 1 satellite operational area. For example Sumatra Island consisted of 3 Witel so that it required 3 area managers in the management level, 3 area vice managers, and 15 functional managers. Following the re-structuring, the number of Witel is reduced to 7 areas and Sumatra Island only need one area manager who supervises lower number of subordinates. Consequently operational cost has been reduced drastically which in turn greatly reduce PT. Telkom' burden

9. *Creation of A Subsidiary Company PT. Telkomsel*

PT. Telkomsel, a subsidiary established in 1995, which operates cellular telecommunications services, originally 100% owned by PT. Telkom, but in order to support IPO of PT. Indosat, the Minister of Tourism and Telecommunications at that time requested PT. Telkomsel to be converted to a joint stock company in which PT. Telkom holds 51% of its shares and PT. Indosat holds the remaining 49%. The reason behind this requirement was that if PT. Indosat did not have a cellular license, the company value would be much lower and less attractive for privatisation. Development of cellular phone by PT. Telkomsel was conducted in a very short period of time, 6 months, started from Batam, Pekanbaru, Medan, Makassar, Bali, Surabaya, and several big cities in Java, then Jakarta which was dominated by Satelindo (the majority was owned by Soeharto's family). As a result of development strategy, which started from regions and marketing strategy which liberated the use of hand set in its early operation. PT. Telkomsel has now become a *market-leader* in Indonesia's cellular

phone industry with 50% national market share. PT. Telkomsel existence as a subsidiary of PT. Telkom was a preparation strategy towards IPO execution in order to add company value; besides it was also expected to support the main company when fixed line market was saturated, which seemed to be happening.

GOVERNMENT INTERVENTION

In preparing and conducting PT. Telkom's IPO beauty contest, PT. Telkom board of directors was not free from the Government or close-to-power interest group interference. Prasetiantono (2005) stated that several interest groups were trying to seek personal profit (rent seeking) by interfering with PT. Telkom tender process to execute the IPO.[16] An example of this was Morgan Stanley' appointment as the financial advisor which was a compromise made by PT. Telkom management in dealing with pressure made by Siti Hadiyanti Rukmana (Soeharto's daughter). Several interferences from *interest group* are listed in Table 2.

Table 2. Interference towards PT. Telkom Privatisation

Rent Seeking and interest/Pressure Groups
Issue: Involvement of President Soeharto's daughter in the privatisation process **Events:** (1) *Siti Hardiyanti Rukmana (Tutut), President Soehartos' eldestdaughter, lobbied the team of seven to pass Morgan Stanley as one of the global underwriters.* *Time: April 1995* (2) *Martiono Hadianto, Director General of SOEs at the Ministry of Finance, as vice chairman of the 'team of seven' (Telkom's privatisation task force) announced four global underwriters as well as four domestic underwriters. Morgan Stanley was not included. This announcement was delayed one day due to an 'intervention from outside'.* *Time: 18 April 1995*

[16] Toni A Prasetiantono, The Political Economy of Privatization of State-owned Enterprises in Indonesia, *Dissertation*, unpublished, The Australian National University, 2005.

(3) *Setyanto P. Santosa, President Director of Telkom, announced Morgan Stanley as financial adviser on Telkom's privatisation. It was a compromise to accommodate Tutut's proposal.* *Time: 23 May 1995* **Player:** *Siti Hardiyanti Rukmana (Tutut)*
Issue: *Pressure from the crony of the President Soeharto's children to cancel global privatisation* **Events:** (1) *Gunawan Jusuf, of Makindo, urged the 'team of seven' to cancel global listing. Martiono Hadianto was very angry and asked Jusuf to leave the meeting.* *Time: September 1995* (2) *Martiono Hadianto was fired by President Soeharto. He was replaced by Bacelius Ruru as the new Director General of SOEs.* *Time: 4 October 1995.* (3) *In New York, Santosa got an emergency call from Minister Ave. The Minister instructed Santosa to cancel the Telkom's global privatisation in New York and London.* *Time: second week of November 1995.* (4) *Minister Ave told President Director Santosa that the Government would replace him soon. Santosa replied that it would be better to wait until the next general meeting of shareholders.* *Time: End of November 1995.* (5) *Telkom's President Director, Santosa, was replaced by AA Nasution through the general meeting of shareholders. President Commissioner Martiono Hadianto was also replaced by Bambang Subianto.* *Time: 17 May 1996.* **Player:** *Gunawan Jusuf, of Makindo.*

Source: Toni A. Prasetiantono, The Political Economy of Privatisation of State-owned Enterprises in Indonesia, Dissertation, unpublished, The Australian National University, 2005, 281.

Table 2 briefly shows two examples of interference occurred when PT. Telkom privatisation was under process. The first was the interference from President Soeharto's family in the privatisation process in which the player was Siti Hardiyanti Rukmana (Tutut)

towards an appointment of a global underwriter by proposing Morgan Stanley who failed the selection (beauty-contest) stage. Regardless the above-mentioned failure, the Government required PT. Telkom board of directors to appoint Morgan Stanley as the financial advisor.

The second interference was when Soeharto's crony tried to abort PT. Telkom privatisation in the international market for the benefit of several players driven by Gunawan Jusuf from Makindo. This attempt was defeated and PT. Telkom's IPO in international market was still carried out due to decision made by PT. Telkom President Director several hours before listing in New York Stock Exchange was carried out on 14 November 1995.

As a result of this attempt opposing executives were terminated in October 1995. They were Martiono Hadianto (Privatisation Team Deputy) who was laid off as Director-General SOEs, Jusuf Anwar (Head of Privatisation Team) who was fired from his post as Secretary-General Department of Finance; and after the completion of the IPO process, Setyanto P. Santosa was fired from his position as PT. Telkom President Director on 17 May 1996[17] along with several other member of board of directors (i.e. Mulyoharjoko and Wisnu Marantika).

HYPOTHESES

Performance Difference before and after Privatisation

1st Hypothesis

Several aspects such as Return on Sales, Return on Asset, Return on Equity, Real Sales, and Leverage shows that company's performance after privatisation reached an improved level.

Factors Affecting SOEs Performance after Privatisation

2nd Hypothesis

Contextual factors as indicated by deregulation factor, liberalisation versus monopoly, privatisation method, restructuring priority, legal and political demand, and economic growth have a significant

[17] Toni A. Prasetiantono, The Political Economy of Privatisation of State-owned Enterprises in Indonesia, Dissertation, unpublished, The Australian National University, 2005, 282.

positive influence towards revitalisation and change in management after privatisation.

3rd Hypothesis

Internal Employee Share Ownership Program (ESOP), which indicates portion factor of employee share ownership proportion, profit management, and dividend policy have significant positive impact towards implementation of *good corporate governance* after privatisation.

4th Hypothesis

Management revitalisation indicated by change in top executives, *team-work* formation, distribution of power and authority, as well as decision making system has a significant and positive impact towards goal change, control and incentive; change in strategy, structure and culture; and SOEs' performance after privatisation.

5th Hypothesis

Good Corporate Governance as indicated by performance oriented factors, conflict of interest, disclosure, audit committee, and commitment to social environment have positive and significant impact towards goal, incentive and control; change in strategy, structure, and culture; and company's performance.

6th Hypothesis

Change of direction, incentive and control which is indicated by factor of change in goal, management incentive, and change in company' control have a positive and significant impact on strategy, structure, and culture change and company' performance after privatisation.

7th Hypothesis

Change in strategy, structure and culture of organisation, which is indicated by factor of change in company' strategy, organisational structure, and company' culture have a positive and significant impact towards company' performance after privatisation.

PROPOSED MODEL

The proposed model was designed to analyze data using a statistical analysis tool and thus allowing conclusions to be drawn. Mathematical models were used to measure PT. Telkom performance and the results were compiled in time series format. The performance calculation method is based on Megginson, Nash and Randenborgh's research or MNR[18], modified by taking *Earning per Share* (EPS) and *Price Earning Ratio* (PER) into account. Mathematically, performance of privatised SOEs can be measured as follows:

$$Return\ on\ Sales = \frac{Net\ Profit}{Sales} \qquad Real\ Sales = \frac{Total\ Sales}{Number\ of\ Employees}$$

$$Return\ on\ Asset = \frac{Net\ Profit}{Asset} \qquad Leverage = \frac{Total\ Debt}{Total\ Asset}$$

$$Return\ on\ Equity = \frac{Net\ Profit}{Equity}$$

$$Earning\ per\ Share\ (EPS) = \frac{Net\ Profit}{Amount\ of\ Issued\ Share}$$

$$Price\ Earning\ Ratio\ (PER) = \frac{Current\ Market\ Price\ per\ Share}{After-tax Earning\ per\ Share}$$

The addition of EPS and PER was designed to provide a more comprehensive view of market reaction towards privatised SOEs. To reveal factors affecting company's performance after privatisation, the study used a model based on the model build by Cuervo and Villalonga as shown in Figure 1.

1. The model was developed to adapt the privatisation practices in Indonesia, especially in the case of PT. Telkom. This involved an addition of contextual factors (2nd proposition) which consist of deregulation components, liberalisation, privatisation method, and restructuring. The basis of this addition is in accordance with the situation in Indonesia decision-makings in the field of economy are influenced by the three external factors.

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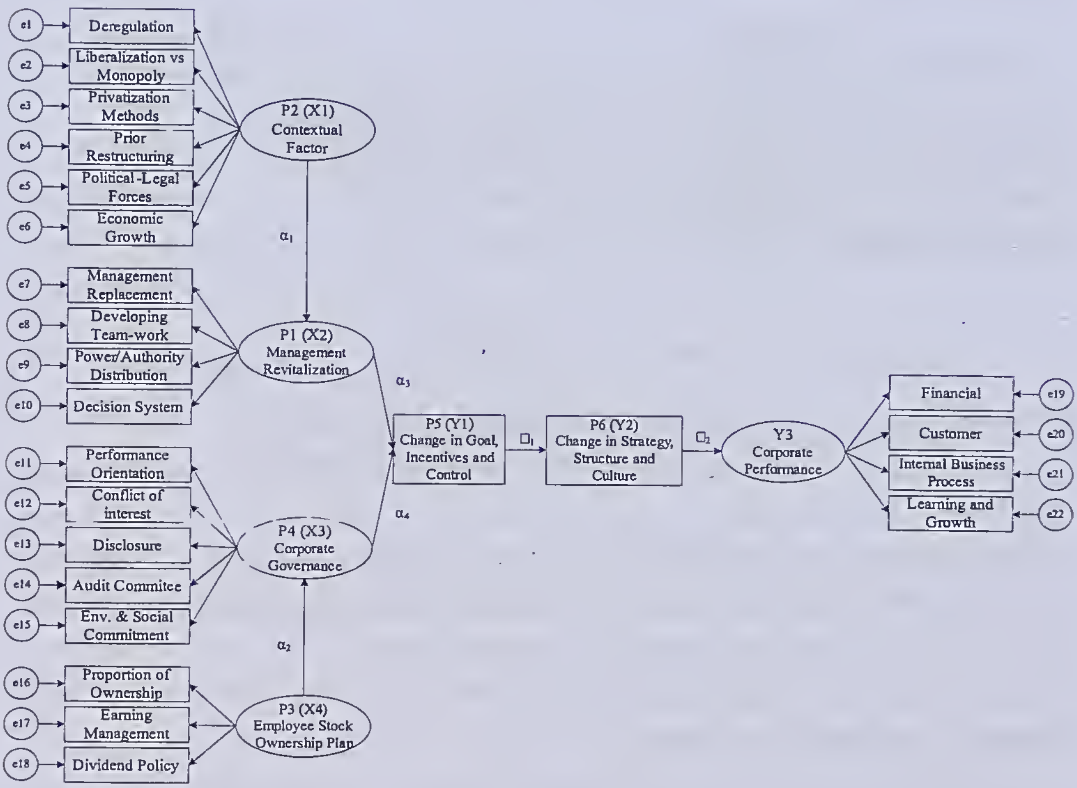
[18] Megginson, William L., Robert C. Nash, and Matthias van Randenborgh,"The Financial and Operating Performance of Newly Privatized Firms: An International Empirical Analysis.," *Journal of Finance* 49, (1994): 403.

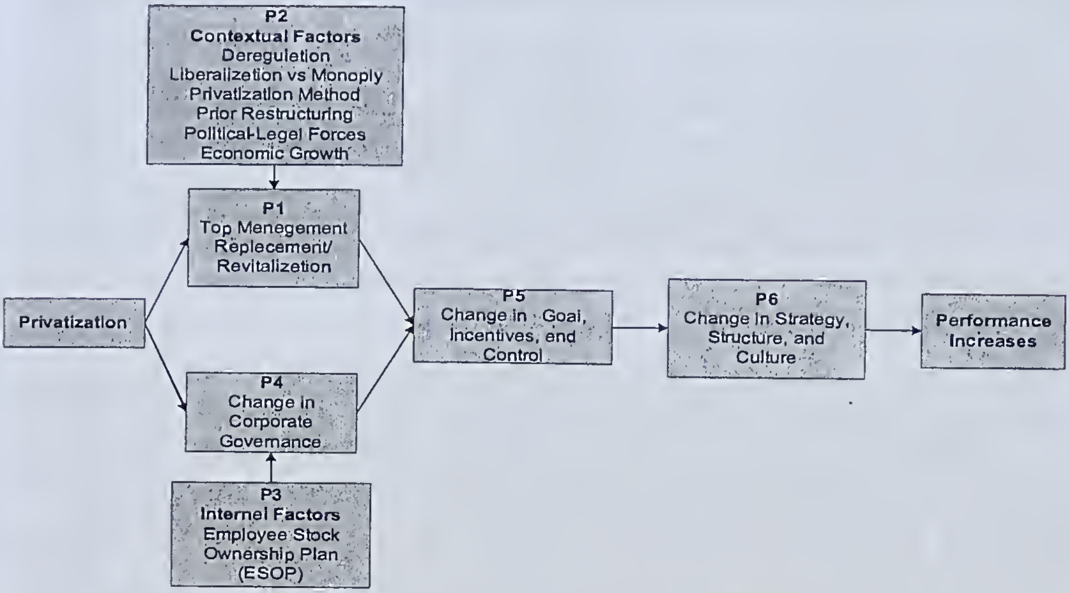
2. The model also included a proposition in relation to *Employee Stocks Ownership Plan* (ESOP) which was not the original model developed by Cuervo and Villalonga. ESOP can be regarded as SOE's internal factor which can affect performance through changes in company management as occurred when PT. Telkom was undertaking IPO.

Figure 2. The Development of Research Model Using Structural Equation Model (SEM)



The model developed in this research, as illustrated in Figure 3, was discussed with Alvaro Cuervo in 2006 in Madrid. Cuervo supported the addition of the above-mentioned variables to incorporate the privatisation experiences in Indonesia.

Figure 3. Modified Model on The Impacts of Privatisation towards Company Performance



In order to get a more comprehensive picture on the impacts of privatisation towards SOEs' performance, an analysis of company's performance before and after privatisation was carried out following the research by Megginson, Nash and Van Randenborgh. The outcomes of this analysis were investigated further to reveal the cause of an increase or a decrease in SOEs' performance.

OUTCOMES OF THE TESTS

The first hypothesis was tested by comparing PT Telekomunikasi Indonesia, Tbk financial performance, indicated by *Return on Sales* (ROS), *Return on Asset* (ROA), *Return on Equity* (ROE), *Real Sales*, and *Debt to Total Asset* (*Leverage*) 10 years before and 10 years after the privatisation. The test was carried out using *paired t-statistic* with n=10 years before and 10 years after the privatisation.

The first hypothesis, which stated that "SOEs' performance after privatisation shows an increased level compared to performance before privatisation", was verified using *paired t-statistic*. As the observations before and after the privatisation were both carried out for 10 years, the most suited method to test the mean difference was *paired t-statistic* or *paired sample t-test*. Positive or negative indicates an increase or a decrease with significant level (*Sig 2-tailed*) ≤ 0.05.

Table 3. The Differences of PT Telkom's Performance before and after

	Paired Differences		T	df	Sig. (2-tailed
	Mean	Std.Dev			
NPM POST - NPM PRE	0.117	0.08193	4.500	9	0.001
GPM POST - GPM PRE	0.255	0.06919	11.662	9	0.000
ROA POST - ROA PRE	0.052	0.0453	3.601	9	0.006
ROE POST - ROE PRE	0.15	0.16422	2.887	9	0.018
DTTA POST - DTTA PRE	-0.013	0.06741	-0.615	9	0.554

Note: POST = before privatisation, PRE = after privatisation, NPM = Net Profit Margin, GPM = Gross Profit Margin, ROA = Return on Asset, ROE = Return on Equity, DTTA = Debt to Total Asset.

Source: data analysis using SPSS.

The significance level used in this research was 0.05 whilst performance differences before and after privatisation were indicated by *Net Profit Margin* (NPM) and *Gross Profit Margin* (GPM) to represent *Return on Sales* (ROS); *Return on Asset* (ROA) and *Return on Equity* (ROE) for profitability ratio; and *Debt to Total Asset* (DTTA) for debt ratio or *leverage*

Based on the above research a number of results can be drawn as follows:

1. Profitability ratio indicated SOE's ability to gain profit, which was measured using *Net Profit Margin* (NPM), *Return on Asset* (ROA), and *Return on Equity* (ROE). Statistical results showed that on average, ROS, ROA and ROE after privatisation had an increase of 11.6%, 5.2%, and 14.9% respectively compared to before privatisation. T values for each of the parameter are 4.5; 3.6; and 2.8 with significance levels of 0.001, 0.006, and 0.018. This has shown a significant increase in the company's profitability. Research outcomes are in line with Megginson, Nash and Randenborgh's research and Boubakri and Cosset's research, which were specifically investigated the telecommunication sector.
2. Debt ratio (*leverage*) indicated *capital structure,* which was calculated from a comparison between debt ratio to SOE's asset value. One of the above statements said that privatisation is expected to reduce SOEs' debt. *Paired t-statistic* test showed that mean debt ration after privatisation gave a 1.33% decrease, the highest t value of 0.615 with a significance level of 0.554. This

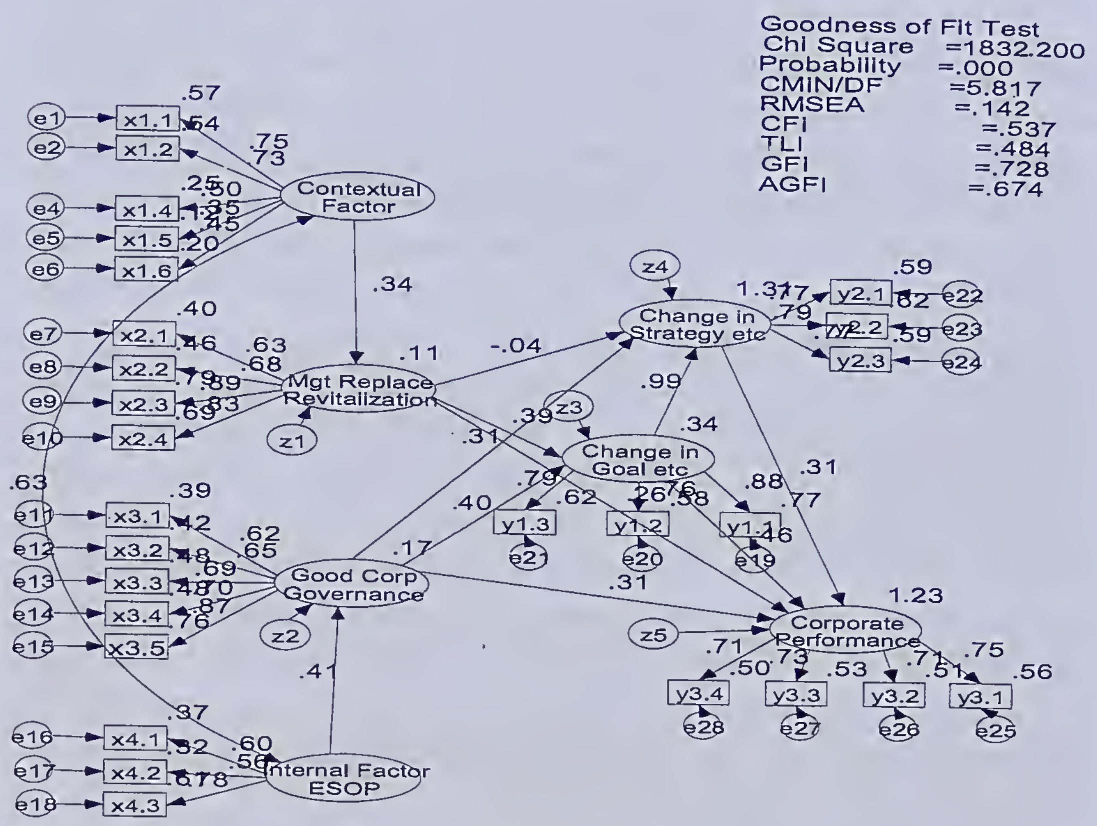
has revealed that privatisation can reduce SOE's leverage level, although the level of reduction is not statistically insignificant.

After privatisation, PT Telkom's performance has increased significantly for a number of financial ratios, such as sales, operational, activity, and profitability, as well as a decrease in debt ratio even though statistically this decrease is not significant. The statistical analysis has verified that the first hypothesis is statistically accepted. Measurement of PT. Telkom's equity performance using *Price Earning Ratio* (PER) approach, which is defined as a comparison between closing price to earnings per share before privatisation could not be conducted. This was due to data unavailability between 1985-1994 because the SOE was not traded in the stock exchange market.

Privatisation has a significant positive impact towards SOEs' performance as represented by PT. Telkom. However, the leverage level has decreased but not statistically significant. but not significant. This indicated that after privatisation PT. Telkom' management still used debt as an alternative funding for investment and expansion. In addition to financial performance, a positive outcome of PT. Telkom privatisation is their contribution towards the development of domestic market exchange in Indonesia.

The second to seventh hypotheses were tested using *Structural Equation Modeling* (SEM], with n= respondent number. Variable measurement was carried out using Likert scale (*five point Likert scale*). Data used in SEM analysis was *cross-section* data obtained from respondent responses. The structural model of privatisation impacts towards PT. Telkom's performance can be seen in Figure 4.

Figure 4. Structural Model Measuring Privatisation Impacts towards PT. Telkom's Performance using Confirmatory Factor Analysis



Goodness of fit indices can be used to investigate if a proposed model can be accepted or has to be rejected as indicated by the degree of correlation. *Goodness of fit indices* evaluation results can be seen in Table 5 below.

Table 5. Evaluation of Structural Model Privatisation Impacts towards PT. Telkom's Performance using Goodness of Fit Indices Test

No	Criteria	Result*)	Critical value**)	Model Evaluation
1.	Chi-Square	1832.200	Insignificant	Marginal
2.	Probability	0.000	0,05	Marginal
3.	RMSEA	0.142	0,08	Marginal
4.	CMIN/DF	5.817	2,00	Marginal
5.	GFI	0.728	0,90	Marginal
6.	AGFI	0.674	0,90	Marginal

7.	TLI	0.484	0,95	Marginal
8.	CFI	0.537	0,94	Marginal

Source: * Data analysis; **Hair, Joseph F., *et.al.*, 1998. *Multivariate Data Analysis*, 5th Edition. Prentice Hall International, Inc., New Jersey.

Note: RMSE = Root Mean Square Error of Approximation, CMIN/DF = Minimum Sample Discrepancy Function, GFI = Goodness of Fix Index, AGFI = Adjusted Goodness of Fit Index, TLI = Tucker Lewis Index, CFI = Comparative Fit Index.

According to the *goodness of fit indices* test, the proposed model indicated a moderate correlation degree which showed a probability of having identification problems. *Goodness of fit indices* test on the modified model has shown better results. The modification was carried out on the basis of modification indices and the test has revealed variable outcomes varied from very good to moderate. This condition indicated that identification problems within the original proposed model can be minimised. Table 6 shows the outcomes of *goodness of fit* test performed on the structural model of privatisation impacts towards PT. Telkom's performance.

Table 6. Evaluation of Structural Model (After Modification) Privatisation Impacts towards PT. Telkom's Performance using Goodness of Fit Indices Test

No	Criteria	Result*)	Critical Value**)	Model Evaluation
1.	Chi-Square	1662.3	Insignificant	Marginal
2.	Probability	0.000	0,05	Marginal
3.	RMSEA	0.136	0,08	Marginal
4.	CMIN/DF	5.415	2,00	Marginal
5.	GFI	0.762	0,90	Marginal
6.	AGFI	0.706	0,90	Marginal
7.	TLI	0.527	0,95	Marginal
8.	CFI	0.586	0,94	Marginal

Source: * Data analysis; **Hair, Joseph F., *et.al.*, 1998. *Multivariate Data Analysis*, 5th Edition. Prentice Hall International, Inc., New Jersey.

Goodness of fit indices test on the modified model has shown an improvement. To find out the impacts of each indicator in a structural model, *line coefficient* of the developed model can be measured. A larger line coefficient indicates a higher influence from the factor in

question towards the whole model. Line coefficient within SEM is equal to regression coefficient in regression analysis or weigh factor in factor analysis. A larger coefficient value indicates a higher influence or a higher degree of interest, and vice versa. To test the significance of factors in a model, *p-value* (*probability* < 0.05) can be used. If *p-value* is greater than 0.05, then influence of a factor towards the whole model is not significant. *Standardised regression weight* and the degree of significance of the modified model are available in Table 7.

Table 7. Line coefficients of Structural Model (After Modification) Privatisation Impacts towards PT. Telkom's Performance

			Est	C.R.	P	Note
Mgt Revitalisation	←	Contextual Factor	1.109	4.061	0.000	Accepted
GCG	←	ESOP	0.807	5.407	0.000	Accepted
Change in Goal	←	GCG	0.444	3.515	0.000	Accepted
Change in Goal	←	Mgt Revitalisation	0.449	3.288	0.001	Accepted
Change in Strategy	←	Mgt Revitalisation	-0.024	-0.632	0.527	Declined
Change in Strategy	←	GCG	0.175	4.394	0.000	Accepted
Change in Strategy	←	Change in Goal	0.500	9.265	0.000	Accepted
Performance	←	Change in Goal	0.200	6.291	0.000	Accepted
Performance	←	Change in Strategy	0.266	6.037	0.000	Accepted
Performance	←	Mgt Revitalisation	0.131	2.734	0.006	Accepted
Performance	←	GCG	0.149	3.806	0.000	Accepted

Source: data analysis

The hypotheses were tested on the bases of line coefficient and probability (p-value). If *probability* is < 0.05, the relationship between variable is significant, and on the other hand, if *probability* is > 0.05, the relationship between variable is not significant. The hypotheses were verified by analyzing the directions of relationship (positive – negative) which is identified by *loading factor* number and by analyzing the level of significance *p-value.*

Statistical analyses undertaken have shown that, all analyzed factors have positive and significant impacts towards SOEs' performance after privatisation, except the change and revitalisation of management, which have negative and insignificant impacts on the changes of strategy, structure, and organisational culture. The model developed in this research is recursive with marginal result from *goodness of fit* test as an acceptable condition, even though the measure of *goodness of fit* is at a marginal level

The model of privatisation used by PT. Telkom during the privatisation process has been applied to other SOEs with modifications according to the type of industry. However, it is recommended that in the future privatisation of any SOEs the Government should minimise interventions, and reduce their active participation in the management of the SOEs. According to Prasetiantono, privatisation of SOEs in Indonesia (especially in the case of PT. Telekomunikasi Indonesia Tbk) is still very much influenced by a number of political interests and government interventions.[19] The Government was also too dominating in the privatisation process.[20]

Management initiatives, government supports, as well as simple procedure and deregulation (as opposed to intervention). are preconditions that must be considered before privatisation is undertaken. To this day privatisation process in Indonesia is conducted mainly for economic reason and as an attempt to cover the Government budget deficit, which are not beneficial for privatised SOEs' value. Deregulation of privatised sector needs to be prepared to ensure that privatised SOEs are able to increase its performance.

LESSONS TO LEARN

Privatisation programme using divestation method (selling the Government's shares) will not give direct effect to SOEs since it does not affect capital size. What happened was only a change in ownership, which changes the dividend right from the Government to the new owner (private sector). Income from equity sales received and passed to State budget will be used in the same fiscal year. In short term, this kind of privatisation generates cash, but in the long term will not be beneficial for the State budget since dividend income will be smaller in the following years.

[19] Toni A. Prasetiantono, The Political Economy of Privatization of State-owned Enterprises in Indonesia, Dissertation, unpublished, The Australian National University, 2005, 279-280.

[20] Muhamad Machmudin Jusuf, Privatization of Public Services: Study on The Political Dimension of The Policy in Constructing Cawang-Tanjung Priuk Highway [in Indonesian], Dissertation, unpublished, Department of Social and Politic, Gadjah Mada University, Yogyakarta, 2005,.

It would be more favourable if privatisation is directed towards new shares issue (dilution) for business expansion, and if necessary government's shares can also be sold. With this way SOEs can get low cost capital to survive in the future. Capital gained from sale of government equity can be used to cover State budget deficit, so it can be used to stimulate economy. Assuming that market has the same absorbing capacity, investor can obtain shares from two different sources (shares already in the market and new rights issue). When SOEs capital has grown bigger, lower level of state ownership makes government less able to interfere.

It is desirable to direct the equity sales distribution to public investors to ensure an equal distribution. This way, public control or *check and balance* mechanism will work better. Equity sales to *single majority* should be avoided especially to vital and strategic SOEs due to the long-term risk it can cause. Even though it is done through an open tender, equity sales to *strategic investor* still bear risk of creating corruption, collusion, and nepotism. On the other hand, public equity sales do not need a tender process. In normal mechanism, if the number of investors is more than expected, fixed allotment will be a way out. This privatisation can also be used to evenly distribute national asset, which is not supposed to be held by certain minority group.

SOEs stakeholders consist of a lot of parties, not only politicians, but also include employees, customers and regulators. Parties included in the *stakeholders* should be given a chance to submit ideas in privatisation process. By involving every stakeholder privatisation will not be creating controversy. On the other hand, privatisation process can be used to increase SOEs' image since privatisation process can bring benefits to more *stakeholder*, equalisation, and investor' control on SOEs business course. For SOEs management, privatisation can be a strategic policy to increase SOEs management efficiency. Privatisation is expected to stimulate implementation of *good corporate governance* in SOEs environment as well as creating *good public governance* in public sector.

Sale of public assets to private sector can reduce government role in allocating public resources to society. Development orientation, which is based on fast economic growth require both domestic and

international private sector participation to be involved actively in the national development process. Privatisation goal and consideration is different for every country. Political consideration, especially in carrying out privatisation, is to give knowledge that government burden is already too big. In the meantime, the private sector is already able to do a lot more effective and efficient economic activity compared to government institutions

SOEs Privatisation process should be done in a careful and useful manner by considering precise *timing* and clear criteria on SOEs that can or will be privatised. Internal SOEs preparation should be done as early as possible so that when it is ready, privatised SOEs, or change status to private company, and government ownership is less than 50%, then said SOEs has become a private company. Even though it is already changed to private company, government still can control it as long as *preferred-stock* or A shares (*golden-share*) is still owned by the Government. Privatisation is also expected to change SOEs' image into a professionally operated *commercial entity* by releasing itself from bureaucratic interference, erasing corruption, collusion, and nepotism in its internal management, and seriously hold the *good corporate governance* principle from the highest executives to employees.

In the case of PT. Telkom, if it is desirable to be operated like a private company, then government ownership, which is currently 51% should be reduced to below 50%. Then PT. Telkom management will be more agile and capable to do business maneuvers in response to competition. If 51% ownership is not changed, then various policies applicable to SOEs will also be applicable for PT. Telkom, causing its status as international public company to be not optimal as it should be. This condition will cause the company to move very slow and unable to face its competitor which has a higher degree of freedom to bring the company towards a better direction.

RECOMMENDATIONS

From discussions on privatisation program in Indonesia there are several points to recommend as follows:

1. In the globalisation and free market era, the Government should start to reduce its role and intervention to SOEs management. Political interest behind SOEs management process and privatisa-

tion should be minimised using deregulation, market mechanism, and privatisation. Decrease in government intervention in SOEs is expected to increase efficiency and affectivity in SOEs management. The social and political cost borne by SOEs management can disrupt SOEs value creation and *core competence* increase to compete globally.

2. Government intervention and regulation can only be done when market mechanism is not working properly (*market failure*). When market mechanism in a sector is working properly, intervention and regulation becomes a distraction and give negative impact. Monopoly and special rights given to SOEs will decrease SOEs competency potential in the long run. Implementation of market mechanism in every economic sector is a must to encourage an effective, efficient, and competent SOEs management.
3. Before undertaking privatisation program, the Government and SOEs management should pay attention to several pre-conditions, which can support privatisation success. They are: (1) economic deregulation and reduced government intervention, (2) market liberalisation through competition creation and abolition of SOEs exclusive rights, (3) privatisation method which can encourage private sector role and clean from Corruption, Collusion, and Nepotism practices (widely known as KKN in Indonesian), (4) business restructuring priority for privatised sector, (5) political and legal aspect as the background of privatisation policy, and (6) conducive economic and investment climate.
4. Before privatisation takes place, SOEs management preparedness in conducting privatisation process is a pre-condition that needs to be observed. SOEs management should be able to undertake organisational change as a result of change in ownership through management restructuring and revitalising smoothly. Several management policies like reducing numbers of employee (if necessary), change in organisational vision, mission, goal and strategy; as well as change in organisational structure and culture needs to be carried out carefully. Privatisation can encourage *good corporate governance* (GCG) and *best practice* for SOEs
5. In order to get an optimum result and minimum political intervention, the ideal privatisation method is *initial public offering,*

which is meant to: (1) encourage private sector and individual investor participation to own SOEs equities, (2) to avoid corruption, collision, and nepotism practices in the offering process, (3) to increase equity market growth and capitalisation, and (4) to enhance public sector' role and participation in accessing the capital market.

6. In order to increase performance and encourage SOEs value creation after privatisation, the management can do several things such as: (1) restructuring and revitalising; (2) consistently and consequently implement *good corporate governance* and *best practice*; (3) boosting internal performance by deciding on *employee stock ownership plan* policy; (4) decide on clear and measurable organisational vision mission, and goal; and (5) perform positive organisational and structural change and attractive incentive scheme to increase company's performance.

THE EVOLVING POLITICAL LANDSCAPE

Sunny Tanuwidjaja

INTRODUCTION

The results of the April 2009 legislative election signified that politics in Indonesia is changing, and it is changing fast. Looking at the trend since the first democratic election after Soeharto, Indonesian politics is still looking for its equilibrium, if there is ever one. The 2009 election result (see Table 1) affirmed that political competition in Indonesia remained highly volatile.[1]

The biggest surprise, although several surveys have also predicted in advance[2], of course is that the Democrat Party (PD) has tripled its vote share and its number of controlled seats in the parliament from 2004. PKS and PAN electoral performance were unexpected. Although failed to achieve its double-digit target, 8 percent votes for PKS came

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1 Johnson Tan. 2006. "Indonesia Seven Years after Soeharto: Party System Institutionalization in A New Democracy." *Contemporary Southeast Asia*, 28, no. 1: 88–114; Andreas Ufen. 2008. "Political Party and Party System Institutionalization in Southeast Asia: Lessons for Democratic Consolidation In Indonesia, The Philippines And Thailand." *The Pacific Review*. 21, no. 3 (July): 327–350.

2 Since late 2008 and early 2009 Centre for Strategic and International Studies (CSIS), Indonesian Survey Institute (Lembaga Survei Indonesia), LP3ES, Reform Institute, and Cirus Surveyors Group surveys have predicted that PD will pull a stunning victory in 2009 legislative election. Indonesian Survei Circle (Lingkaran Survei Indonesia), National Survey Institute (Lembaga Survei Nasional), and Puskaptis mistakenly predicted that PDI-P will turn out victorious, while Indonesia Research Institute (Lembaga Riset Indonesia) predicted that Golkar will win the election.

as a surprise because based pre-election surveys, on average PKS is expected to perform worse than 2004. Similar to PKS, based on survey results, PAN was expected to gain only around 3-4 percent of total votes. However, PAN denied the general expectation and gained around 6 percent of vote share.

Table 1. Election Results after The Fall of The New Order The Largest Political Parties

Political Party	1999		2004		2009[1]	
	% vote	# seats	% vote	# seats	% vote	# seats
PDI-P	33.7	153	18.3	109	14.0	95
Golkar	22.4	120	21.6	128	14.4	107
PPP	10.7	58	8.2	58	5.3	37
PKB	12.6	51	10.6	52	4.9	27
PK/PKS	1.4	7	7.2	45	7.9	57
PD	-	-	7.5	55	20.8	150
PAN	7.1	34	6.4	53	6.1	43
Gerindra	-	-	-	-	4.4	26
Hanura	-	-	-	-	3.7	18
Others	-	39	-	50	-	-

The losers are PKB, and three other parties that boasted their historical legacy since there have been present since the New Order: Golkar, PDI-P, and PPP. PKB's vote share declined by half, PPP lost almost 40% of its vote share, Golkar lost around 30%, and PDI-P lost about 20% of its 2004 vote share. With the of 2.5% parliamentary threshold, there are nine political parties that will be in the 2009-2014 parliament. Out of the nine parties listed in Table1, two are newly established: Gerindra and Hanura. Both took advantage of the weakening of Golkar.

How do we explain these results, and particularly what does this mean for Indonesian politics? What should we expect from the 2009 presidential election and beyond?

THE 2009 LEGISLATIVE ELECTION

The central factor in the overwhelming success of PD is the perceived success of the incumbent president, SBY. This factor has two sides. One, in a highly pessimistic atmosphere towards politics and politicians, a president and a politician who promised, proposed, and delivered programmes that directly impact the live of the many

will certainly boost his or her popularity. SBY is known for his BLT, BOS, and PNPM programmes, which provide direct cash assistances to the people, schools, health center, and villages. There is no doubt that the impact of these programs were felt instantly by the people, and no doubt they boosted SBY's popularity.

Second, we should credit this boost of popularity to SBY's political advisors. It was not long ago, June 2008, when SBY's popularity hit its lowest in four years, when he raised the fuel price. The quick and instant measures to counter this decline were the populist programs and massive political advertisement showing how the populist programmes work. SBY and his team were able to establish public perception that he is successful, and respond well to the needs of the people. Although PD do not have party machinery like Golkar and PDI-P, SBY was able to utilise the resources at hand as an incumbent and employ the state structure as his shadow political machinery. Since PD is closely identified with SBY, the rise in SBY's popularity boost support for PD.

Two other hardly noticed success stories in the 2009 election were credited to PKS that gained about 8 % of the total popular votes and PAN that gained more than 6% of the total popular votes. PAN's achievement is considered spectacular due to its lack of experience in leadership and its increasing distance from Muhammadiyah, its traditional base of support. The head of the party was a an ordinary businessman who just lost a huge share of its wealth due to the fall of Bakrie's Bumi share price in the market.

Although failed to achieve its double digit target, 8% votes for PKS came as a surprise because in a political atmosphere where support for Islamic political parties is declining, PKS was able to get more vote than 2004. Unlike PKB that only get half of its 2004 vote, and PPP that was only able to retain 60% of its 2004 vote, PKS gets an additional 1% of its 2004 vote. With the implementation of 2.5% parliamentary threshold, PKS is expected to gain an additional 10 seats in the parliament. PAN's gain is considered spectacular due to its lack of experience leadership and its increasing distance from Muhammadiyah, its traditional base of support. The head of the party was a businessman who just lost a huge share of its wealth due to the fall of Bakrie's Bumi share price in the market.

How did PKS and PAN manage to defy the odds and get more votes than expected? Looking at the survey results one might be able to indicate where the votes come from. Survey conducted by CSIS, LP3ES, P2P LIPI, and Puskapol UI on 9-20 February 2009 shows that there were about 22 percent undecided voters at that time and there was about 9 percent support for small parties that were not expected to pass the parliamentary threshold. The undecided voters voting behaviour in April 2009 is crucial in explaining PKS' and PAN's success.

By comparing the result of the election with the previous survey result we can get some clues. The quick counts and KPU's real count show that PD gets about 20.5% of the votes, Golkar 14.6%, and PDI-P 14.1%. Since these percentages are very similar with the survey result, these three parties failed to lure the undecided voters.

Half of the undecided voters seem to vote for the small parties that fail to pass the parliamentary threshold. The official election result shows that support for the small parties reaches up to around 18%. From the expected 9% support as shown by the survey, the small parties gain about an additional 10 percent vote from the undecided voters. This shows that significant numbers of voters in Indonesia are willing to vote for unknown small parties, which represent a challenge towards the big parties. Their desire for change in politics outweighs their concern about "wasting" their votes.

The other half of the undecided voters voted for the mid-size political parties, particularly PKS and PAN. For those who were concerned about wasting their votes and yet do not like the big parties which represent the entrenched political establishments, these mid-size parties are highly attractive.

Support for PKS seems to decline before the election because of its strategy. In the last several months PKS has been working very hard to position itself as an open, moderate, and pluralist political party. However, this strategy backfired. On the one hand, this strategy failed to lure the median voters. On the other, this strategy disappointed PKS loyalists who tend to be more conservative. In addition, those who voted for PKS for pragmatic reasons, perceiving it as a clean and professional political party began to doubt this image due to a constant attack by other political parties on PKS, several allegations

on PKS members regarding corruption and immorality, and failures of regional heads who are known as PKS supporters. However, despite such problems, PKS was able to regain significant number of its voters. At the end, many of its supporters who were disappointed with the party still voted for it because they assumed there were no better available alternatives.

Meanwhile, PAN employed a strategy to recruit actors/actresses to be its legislative candidates. Although PAN was cynically associated with a new name *"Partai Artis Nasional"* (National Celebrities Party), the strategy to recruit actors and actresses worked effectively. In a political landscape where voters have limited information about the legislative candidates, they tend to vote for the names that are familiar to them. In such situation, popularity means seats in the parliament.

To sum up, it is the disappointment and pessimism towards those who are perceived as entrenched political establishment, the lack of viable alternatives, and the lack of informed voters that allow PKS and PAN to defy the odds and came out victorious in the 2009 election.

To account for the decline of PKB is fairly straightforward. Before the election started, the conflict between Muhaimin, the current chair, and Gus Dur (Abdurahman Wahid) failed to be resolved. Muhaimin was successful in maintaining its position as the official chair of PKB. However, at the grass root level, Gus Dur was able to undermine Muhaimin's legitimacy. In addition, Gus Dur's faction within PKB encourage their voters to either not vote or to vote for Gerindra. Although Muhaimin and his faction claim that everything was under control, the election result shows that the influence of Gus Dur at the grass root level is still very significant.

Golkar, PDI-P, and PPP can be considered the primary losers. As the oldest parties competing in the 2009 election, these three failed to adjust for the changing political trends. In the 1999 election, these three parties experienced stagnation if not a steady decline. PDI-P was the party with the largest support in 1999 with 33.7% of the votes and 33.3% of the seats. However, it had also experienced a steady decline thereafter, gaining only 18.3% of the total votes and 19.82% of the seats in 2004, and even worse, about 14% of the total votes in 2009.

Golkar, which survived the fall of Suharto's New Order regime gained 22.4% of the votes and 26% of the of seats in 1999, but failed to

perform better since then. Although it became the largest party in the parliament in 2004, its vote and share of seat declined to 21.6% and 23.3%, respectively. In the 2009 election, Golkar's support declined to 14% of the votes. PPP also experienced a steady decline. In 1999 PPP gained 10.7% of the votes and 12.6% of the seats and has been in decline there after gaining 8.16% of the votes and 10.5% of the seats in 2004, and got only about 5.5% of votes in 2009.

The primary factor of the steady decline of these "new order" parties is because they chose to depend on and did not upgrade their party machinery and organisation which are outdated and are no longer performing well. They chose to depend on their traditional voters bases, which are already eroded by the invading appeals of the new political parties. The three parties also failed to adjust on the increasing importance of personal and political advertisement. One can just compare the quality of their campaign ads with PD and Gerindra's ads. PD and Gerindra both hired real professional political consultants. Also unlike PD and Gerindra, which have strong and dominant figures, Golkar and PPP do not have any, while PDI-P's Mega is losing her appeal since many consider her to have failed when she was president.

THE 2009 PRESIDENTIAL ELECTION

The end of the legislative election marks the beginning of the presidential election. Three candidates (see Table 2) will compete and if survey can be a clue as in the legislative election, SBY is on his way to lead Indonesia for another 5 years.

Table 2. Candidates and Political Party Support

	Candidate 1	Candidate 2	Candidate 3
President	SBY	Megawati	Kalla
VP	Boediono	Prabowo	Wiranto
Parties	PD, PKS, PPP, PAN, PKB	PDI-P, Gerindra	Golkar, Hanura
% Parties' vote	45	18.1	18.4

The last survey result done by the Indonesian Survey Institute (data collection was conducted from 27 April to 3 May 2009) shows that SBY-Boediono pair is overwhelmingly popular with at least 70% of potential voters supporting their candidacy. Unlike other

presidential candidates who select their running mate in order to fulfil the threshold requirement to run as candidate and to gather support to beat SBY, SBY's primary concerns in selecting a running mate seems to avoid a drop in popularity and to create a stable and effective government for the next 5 years.

The public knows very little about Kuntoro Mangkusubroto, director of the Rehabilitation and Reconstruction Agency for Aceh and Nias (BRR), and he has not proven that he is as good of a politician as Boediono. Although Boediono does not come from any political parties, he has shown his ability to nail agreement with and persuade politicians when he was the finance minister under Megawati. The other candidate from the technocrat group is the current Finance Minister, Sri Mulyani. Apparently SBY has not so positive experience with Kalla--an aggressive, quick, and full of initiative vice president who has similar characters with Sri Mulyani. These qualities seemed to have discouraged SBY to select her.

Of the three potential candidates from the political parties, each has his own weakness. The selection of Hatta Radjasa from PAN as a running mate for SBY was rejected by PKS, the second largest political party in SBY's coalition. Hatta is also a risky choice for SBY because the two have been dubbed to be going to have a family relationship as in-laws in the near future, making SBY vulnerable for nepotism allegation. Aburizal Bakrie is known as the primary contributors for SBY although he is a Golkar member. His company has not yet resolved the mud disaster in Sidoarjo, East Java. Choosing Bakrie will make SBY vulnerable to the allegation that he is the patron of the rich. Lastly, Hidayat from PKS is risky for SBY because the voters still consider PKS as a conservative and extreme rightist political party. Choosing Hidayat will certainly alienate the more nationalist voters. Aside from his economic credentials, SBY selects Boediono because he is the safest choice. A choice with the least risk.

The other two candidate pairs know that they have a very small chance to beat the incumbent president. The primary competitor for SBY is Mega and Prabowo pair. The pair expects to get support from PDI-P and Gerindra voters. Although PDI-P and Gerindra are better in consolidating voters to support the candidate the party proposed, their total voters are merely around 18%. Their message of change,

compared to SBY's message of continuity, is less appealing since SBY has been considered by many as a somewhat successful president, particularly when compared to the presidents in the reform era. Mega lacks the credibility because her presidency from 2001 to 2004 and was considered a failure by many. Prabowo still has trouble detaching himself from the allegation of human rights violations.

The Jusuf Kalla and Wiranto pair expects to get support from Golkar and Hanura voters. This is a problem, however, since compared to other big parties such as PDI-P, PD, and PKS, Golkar is the least capable in translating their party supports to presidential candidates supports. While the majority of PDI-P voters support Mega, PD voters support SBY, and PKS voters support SBY for president; the support from Golkar's voters are spread equally among several individuals, such as SBY, Jusuf Kalla (JK), Sultan Hamengkubuwono X (Sultan), and Megawati. Factions within Golkar are trying to get SBY's attention, knowing that he is most likely going to win. The potential strength of this pair is in Kalla. As part of the incumbent government and yet running to challenge SBY, Kalla can bridge the two opposite themes of his two competitors; SBY offering continuity, and Megawati offering change.

Although SBY is expected to win a landslide, the potential deadlock between the executive and legislative in the next 5 years is still looming due to the nature of a presidential multi-party system. SBY's coalition controls around 45 to just below 50% of the parliament seats, a hardly adequate support for a stable government. Moreover, coalition agreements in Indonesia, although said to be binding, lack credibility because they lack mechanism to punish defectors. This is the primary reason why SBY and his close advisors have mentioned several times that they are trying to forge a coalition that control around 70% of the cabinet seats.

However, Indonesian political elites have been able to work together fairly well (Slate 2004, 2006). Deadlock should not be a concern. We should expect that despite Golkar and PDI-P are competing against SBY in the coming presidential election, both parties are very likely to become friendly and accommodative towards the incumbent.

If Kalla losses this election, and most likely he will, he will certainly lose Golkar top position. Bakrie and Surya Paloh are expected to

fight for Golkar's top position. Whoever wins will be under pressure to bring Golkar closer to power; and the lure of being part of the governing coalition will be attractive to reject. Golkar has a history of being close to power, and its members will not allow Golkar to become an opposition in the near future.

Signs of future "cooperation" between PD and PDI-P are also emerging. Only after PDI-P met with Hatta Radjasa for the second time that Boediono became the clear front-runner as SBY's presidential candidate. This indicates that despite Mega will compete with SBY in the presidential election, PDI-P is open to work with PD. Boediono is known for his close relationship with Megawati. Megawati is fond of him because Boediono have shown strong respect to Mega. By choosing Boediono as his running mate, SBY signals his openness to accommodate PDI-P and Mega's interests.

[1] Pending upon further review of the Constitutional Court and some rounding errors. Source: www.Kompas.com

MODERATE GROWTH AT TIMES OF GLOBAL SLUMP

Deni Friawan and *Teguh Yudo Wicaksono*

INTRODUCTION

After experiencing a robust economic growth during the first three quarters (the economy grew averagely by 6%), Indonesia witnessed its decelerating economy for the last two consecutive quarters. Performance of international trade continues to decline and capital market is trimming down. In that case, the resurgence of the economy will depend on the recovery of external sector and the government expenditure through fiscal stimuli. Some policy measures are in dire need, particularly those addressing international trade and domestic consumption. In order to maintain modest growth during the global recession, the government needs a policy stipulating tax and import-duty incentive for export-oriented raw materials.

ECONOMIC GROWTH

After experiencing a strong economic growth in the first three-quarters in 2008, the economy witnessed a rapid downturn in the last two consecutive quarters. Indonesia grew by 4.8% in Q4 (y-o-y) and continued to slow down in the first quarter of 2009 (4.4 %). The slowing down in global economy leading to a downturn in export demand for Indonesia merchandise is the main reason behind the dramatic nose-diving in Indonesia's economy. Growth is still modest, however, as we juxtapose Indonesia's economy in the context of region.

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Expenditure Side: Strong Consumption yet Poor Trade

At the time of global recession getting worse in the mid of 2008, consumption, particularly private consumption (y-o-y), experienced a robust growth. By Q4 of 2008, private consumption grew by 6.3% (y-o-y) and accelerated by growing around 7.2%. Moreover, fiscal stimulus introduced by the government in the beginning of 2009 seemed to have an effect in the first quarter of 2009. The government consumption in the Q1-2009 grew by 7% which was higher than that in Q1-2008. In terms of contribution to GDP growth component, it becomes evident that consumption contributed largely to economic growth in the first quarter of 2009.

Table 1. GDP Growth by Consumption 2008-2009

	2008				2009
	Q1	Q2	Q3	Q4	Q1
GDP Growth					
Private Consumption	5.5	5.5	6.3	6.3	7.2
of which food	5.7	5.5	5.3	4.7	5.8
of which non-food	4.7	4.5	4.2	3.6	4.5
Government Consumption	6.5	6.5	6.3	5.7	7.0
Gross Domestic Fixed Capital Formation	14.5	12.8	11.5	9.8	3.5
Change in Stock	-408.2	-68.7	-65.4	-60.8	-146.1
Exports on Goods & Services	14.2	-93.8	-91.1	-109.4	-95.4
Imports on Goods & Services	18.0	16.1	11.0	-3.3	-24.1
GDP	6.2	6.6	6.4	4.8	4.4
% Contribution to growth					
Private Consumption	53.1	47.8	46.6	57.8	76.9
of which food	20.9	18.2	17.2	20.4	27.5
of which non-food	32.2	29.6	29.4	37.3	49.3
Government Consumption	3.8	6.3	16.2	31.7	28.0
Gross Domestic Fixed Capital Formation	50.4	42.6	40.3	48.0	18.6
Change in Stock	15.7	-5.6	-9.5	13.6	-23.1
Exports on Goods & Services	107.6	-679.8	-662.8	-1,116.5	-1,101.8
Imports on Goods & Services	106.9	92.9	66.1	-27.3	-225.0
GDP	100	100	100	100	100

Source: CEIC Asia database

After growing robustly in the 2008, investment decelerated in the first quarter of 2009. By Q1 of 2009, investment grew at 3.5% which was far lower than Q1-2008 (14.5%). Concern over global recession, which may go deeper than we thought sparked pessimism for the future growth and it is reflected by nose-diving trend of investment. The source of slowing down in investment can be attributed to a downturn in machines, equipment and transportation for both foreign and domestic. The most dramatic decline was foreign machines and equipment investment which witnessed a contraction by 9 % (it grew by 46 % in Q1-2008). It was followed by domestic machines and equipment which contracted around 7 %.

While most components of investment tended to decelerate or even contract, it was only construction, which accelerated in Q1 of 2009. Spending in construction, moreover, continued to drive investment growth (growing by 6.3% of GDP growth in Q1 of 2009), possibly because of an increase in housing and office investment taking place in 2008.

Furthermore, the slowing down of economy led by external demand became evident in the Q4 of 2008 and Q1-2009. By Q4 of 2008, export plunged significantly (declining by 109.4%) and it continued to contract in Q1-2009 (-95.4%). This weak export growth was mainly driven by global economic meltdown in major export destination countries (such as Japan and the US). In the same vein, imports also witnessed a contraction in the last two subsequent quarters. Imports grew negative at -3.3 % in Q4-2008 and continued to decline by -24.1% by Q1-2009. Large cut in imports came from raw material used for export-oriented production. As external demand falls, demand for foreign materials used for export also declines.

Table 2. Investment Growth 2009

Gross fixed capital formation	2008				2009
	Q1	Q2	Q3	Q4	Q1
a. Construction	8.0	8.1	7.6	5.7	6.3
b. Domestic machines and equipments	16.6	9.0	-0.7	-9.4	-7.0
c. Foreign machines and equipments	46.0	29.8	29.5	27.6	-9.0
d. Transportation tools, domestic	18.3	7.4	12.9	13.5	2.5
e. Transportation tools, foreign	53.0	58.0	33.4	33.7	12.9
f. Others, domestic	5.1	7.2	7.1	15.7	5.3
g. Others, foreign	66.2	40.5	15.9	23.1	-19.8

Source: CEIC Asia Database

External demand is no longer the major component contribution to GDP growth as it used to be between 2004 and the early 2007. Though investment contributed significantly in 2007, thanks to optimism upon long-term growth, it now suffered nose-diving trajectory. Consumption, on the other hand, takes the lead as the major component of GDP growth. Fiscal stimuli encouraging consumption is in need, particularly to boost domestic demand and adjust to a decline in external demand. An incentive on income tax, particularly intended for middle income, is an example of this policy.

Compared to other ASEAN countries, Indonesia's economy is relatively strong amid the global meltdown as reflected by her GDP growth. Indonesia also showed her resilience under international economic pressures, which proved to be a good signal. Yet, there is no room for complacency in regard to the global economy turmoil. Hence, the policy makers should be able to capitalise this advantage. In order to maintain investor confidence, Indonesia needs to instigate credible policies.

Table 3. The GDP Growth of Selected ASEAN Countries

Country	2007	2008	2009*	2010*
Indonesia	6.3	6.1	2.5	3.5
Thailand	4.9	2.6	-3.0	1.0
Phillippines	7.2	4.6	0.0	1.0
Malaysia	6.3	4.6	-3.5	1.3
Vietnam	8.5	6.2	3.3	4.0

Source: IMF. 2009. "World Economic Outlook: Crisis and Recovery," World Economic Outlook published by International Monetary Fund, Washington DC , * predicted value

Production Side: Modest Primary Sector, Poor Manufacturing, Strong Services

The growth rate for the primary sector (agriculture) shows an accelerating trend. After decelerating during Q1-Q2 of 2008, agriculture had shown an increase in Q1-2009 by 4.79%. Agricultural growth is modest because of robust non-food crop, growing by 24.1%. International commodity price effect is the major driver behind this growth instead of demand. On the other hand, mining, quarrying, oil and gas sector have grown positively since Q3-2008. A reversal trend in this sector was due to solid growth of quarrying and mining, which grew by 6.4% and 5.2% respectively.

Manufacturing recorded poor performance during the last two subsequent quarters. Petroleum and gas manufacturing has shown contraction for two consecutive quarters. At the same time, non-oil and gas manufacturing has decelerated since Q4-2008. It grew by 1.85% and 1.62% for Q4- 2008 and Q1-2009 respectively. It is clear that manufacturing sector with high exposure to international trade plunged significantly. Wood products decelerated by growing by 3.18% in Q1-2009 while it increased by 7.6% in Q4-2008. Cement and non-metallic mineral, iron and basic steel, and transport equipment and machineries experienced contraction (they grew by -4.7%, -9.9% and -5.9% respectively). Among non-oil manufacturing sector, food, beverages and tobacco experienced the strongest growth, which increased rapidly by 13.9%.

Some service sector continued to experience robust growth, with transportation and communication as the leading sectors. The continual boom in the communication subsector, which has grown since 2007, drove the sector's rapid expansion. The utilities sector, namely, electricity, gas, and water supply, also continued to grow rapidly by 11.4% in Q1-2009. Robust growth in the sector was supported by swift growth in subsector gas supply, which grew noticeably by 38% in Q1-2009. The nationwide energy conversion programme for household from kerosene to gas which still takes place may be the reason behind this strong growth.

Table 4. GDP Growth by Production 2008-2009

	2008				2009
GDP Growth	Q1	Q2	Q3	Q4	Q1
1 Agriculture	5.88	5.69	3.61	3.60	4.79
2 Mining	-1.64	-0.44	2.12	2.19	2.16
3 Manufacturing	4.28	4.23	4.31	1.85	1.62
4 Electricity, Gas & Water	12.35	11.77	10.41	9.09	11.42
5 Construction	-0.13	-3.14	2.18	2.08	0.94
6 Trade, Hotel & Restaurant	6.88	8.32	8.45	5.15	0.57
7 Transport & Communication	18.21	17.86	15.69	13.47	16.68
8 Business Services	8.34	8.66	8.60	7.42	6.27
9 Services	5.85	6.74	7.19	6.01	6.81
GDP	6.2	6.6	6.4	4.8	4.4

Source: CEIC Asia Database

Growth Outlook

Global financial turmoil has taken its toll since the Q4-2008. Indonesia economy has been slowing down afterward. Though the last review of economic development concluded that the economic prospect of 2009 will be gloomy[1], the growth of Q1-2009 showed us that the economy is not as gloomy as we thought. The government spending, through fiscal stimuli in infrastructure projects would lift the potential growth up. Income tax incentive is also expected to have an effect by encouraging private consumption. Based on the previous review, we also maintained our growth estimate at around 4-5% for 2009. This estimate is also based on the fact of solid domestic demand and sharp banking sector which maintain investor confidence and credit market. The government plan to increase public servant's salary would increase household spending.[2] No less important is the election year, which may boost consumption. The 2004 election year showed us that campaign-induced consumption contributed to 1-1.5% of economic growth.

MONETARY DEVELOPMENT

Inflationary pressure grew moderately in Q1/2009. The CPI inflation was registered at only 0.36% (q-t-q), or 7.92% per annum. Meanwhile, the exchange rate was continuously under downward pressure due to adverse external conditions. Rupiah depreciated by 5.67% (p-t-p), with the currency falling to IDR 11,555/USD. In line with the global development, moreover, domestic financial and stock market also showed a downward trend due to negative sentiments from external factors and in the absence of improved corporate performance. Even so, some improvement was reported at the end of the Q1/2009, leading by the better than expected outcome in the balance of payments and improving perceptions of risk.

Inflation: Continues to Ease

Inflationary pressures continued to ease in the first quarter of 2009 for the reasons of continuously falling commodity prices, slower

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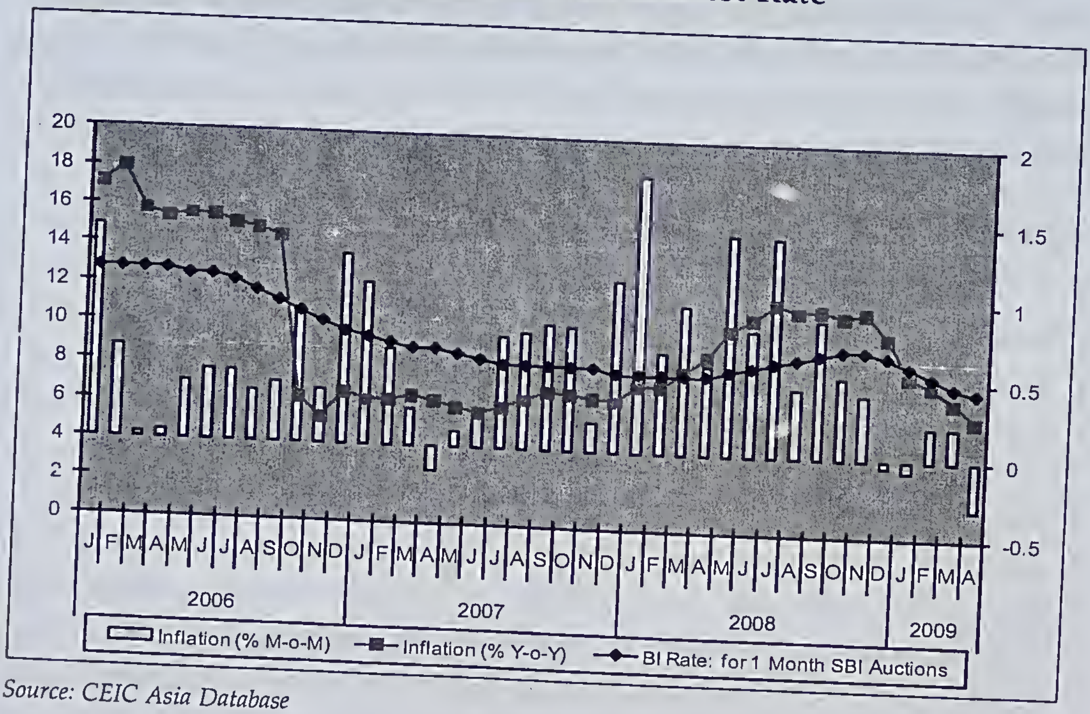
1 Hirawan, Fajar B and Widdi Mugijayani. 2009. "*Review of Economic Development: Growth Plunge along with the Global Meltdown.*" *The Indonesian Quarterly* 37, no. 1.

2 Ibid.

pace of the economy, and cuts in consumer spending. In Q1-2009, annual inflation dropped from 8.2% in January to 7.0% in March. Similarly, monthly inflation was also kept at low rates, ranging from -0.07% in January to 0.2% in February and March, respectively. The declining trend of inflationary pressure is mainly led by the ongoing first round and second round effects of fuel prices cut. In addition, the improvement in expected inflations, softening domestic demand, as well as lower pressure of administered prices and volatile—as domestic food crop production maintained at adequate levels, has also contributed to the easing inflationary pressure in the first quarter of 2009.

Figure 1: Indonesia CPI Inflation and Interest Rate



Source: CEIC Asia Database

Interest Rate: On the Downward Trend

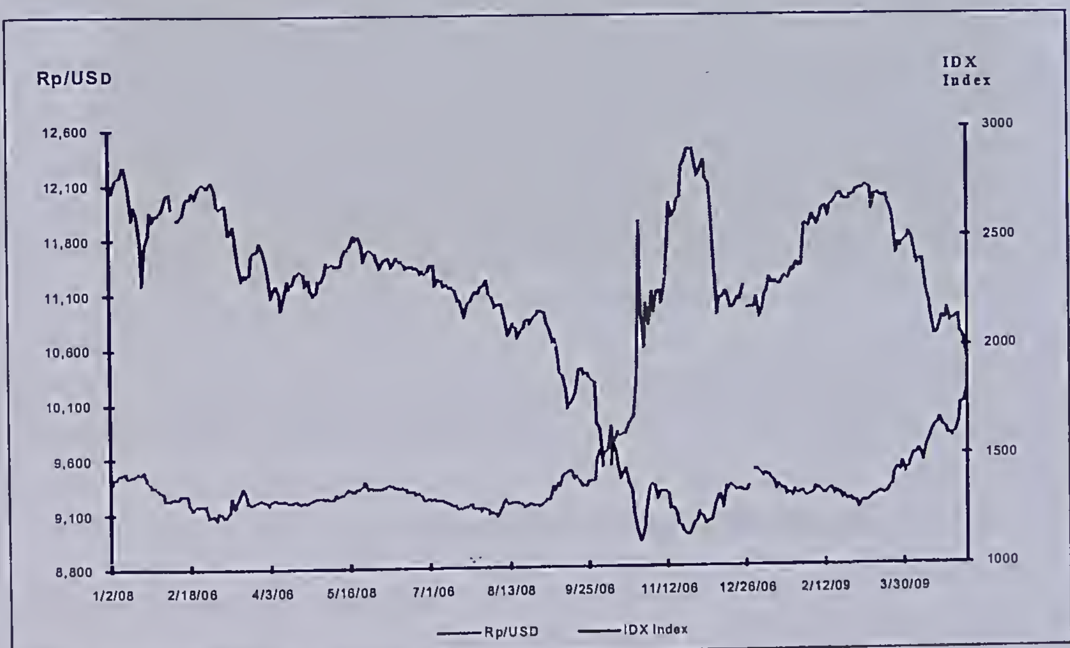
The low-inflation environment provides room for further interest-cut. Noteworthy, the cut is crucial to boost the economy moves amid the fear of global financial crisis. The Indonesian central Bank, Bank Indonesia (BI) cut its key interest rate, locally known as the BI rate, three times by 50 bps each month during Q1-2009, bringing the BI rate declined from 8.75% in January to 7.75% in March.

The cut, however, was not immediately followed by interest rate cut by commercial banks. The credit interest rate remained stubbornly high. The lack of liquidity in the financial system, combined with currently quite high business risk in the country, seemed to have prevented banks from translating an immediate drop in their lending rates.

Exchange Rate and Stock Market: Under Constant Pressure

The IDR to US dollar exchange rated to be under pressure in Q1-2009, mainly due to negative sentiment from external factors. The rupiah declined from IDR10,914/USD in the previous quarter to IDT11, 578/USD, or depreciated by 5.7% during the respective quarter. The downward trend of rupiah was driven by the worry about the impact of the global economic crisis on Indonesia's domestic market. As a result, investors prefer to keep the US dollars, which are perceived to be safer than the Rupiah.

Figure 2: The Exchange Rate and Stock Price



Source: CEIC Asia Database

Moreover, a slightly higher demand of US dollar from the domestic business also added downward pressure to rupiah. Thanks to the central banks' prompt response in guarding the rupiah not to slide

further than IDR12,000/USD. The central bank, however, persistently appear in the market, by continuously taking actions to monitor and minimise volatility of the exchange rate.

The pressure on rupiah eased at the end or the quarter on the positive market sentiments, both locally and globally. The central bank's further interest rate cut in the beginning of march and a better than expected performance in the balance of payments as well as the reported earning on new loan from some international financial institutions and the policy response of the Fed led to the up-ward trend in rupiah. For the last, the Fed planned to by treasury bonds worth US$ 300 billion pumped liquidity to the market and created downward pressure on the US dollar.

Meanwhile, driving by the falling commodity prices and on the worry about falling corporate earnings, Indonesia shares continued to tumble in Q1-2009. In line with the weakening rupiah and falls across Asian Market, Indonesian stock market exchange (IDX) index turn down from 1,437 in the beginning of Q1-009 to its lowest level of 1,256 on 2 March. The good news on a bump in oil prices, the cut of guarantee bank interest rate up to 50 bps, and the approval of the US government's economic stimulus package seemed to have only supported the index for awhile, overshadowed by the negative market sentiment over the news of worsening world economy and the recorded slow of Indonesia's economic growth in Q4-2008.

However, Indonesia shares experienced positive bias in the end of March. The positive sentiment came from the report of strong performances of most public companies and the easing February inflation revived the interest on banking, telecoms, and commodity related stocks as it was now undervalued, and hence led to the advance on the back of a rebound in the IDX index. After hit its lowest level, Indonesia maintained an upward trend and reach its highest level of 1,462 on 27 March.

Prospect

While the inflation has been well checked, some internal and external pressures still remain. The central bank is expected to operate in low inflation environment in the next couple of months, or even for the whole year. Inflation is expected to ease further

during 2009 and forecasted to the lower limit of the 5%-7% range. On domestic side, the lower inflationary pressure is primary caused by the improvement of public inflation expectation going after the slush in oil prices and transport fare, and the secure supply and smooth distribution of domestically produced goods. On the external side, falling international commodity prices have lowered price of imported goods, and thus inflation. Even so, inflation may overshoot the prediction in the event of expected outcomes in a range of influencing factors, such as shortfalls in food crop production and higher oil prices.

Meanwhile, despite the on-going rupiah appreciation, as well as some positive prediction in the coming next few months, rupiah remains prone to go back to weaker position. At the moment, a rather high interest rate return from investing in Indonesia—vis-à-vis investing in other countries–seems to be the main reason for the country's exchange rate appreciation. This phenomenon, which is often referred to the *carry-on trade* could pose some risk to the exchange rate, should some, even small, shocks disturb the current atmosphere of the Indonesian economy. In addition, the upward trend of the Rupiah could also be flattened since some companies, such as state electricity company (PT PLN) and state oil and gas company (Pertamina), would have to pay their matured foreign-exchange debt.

Given the situation mentioned above, the central bank seems to remain precautious regarding the possible rupiah depreciation before implementing further rate cut, although the relationship between interest rate and exchange rate seems becoming weak recently.

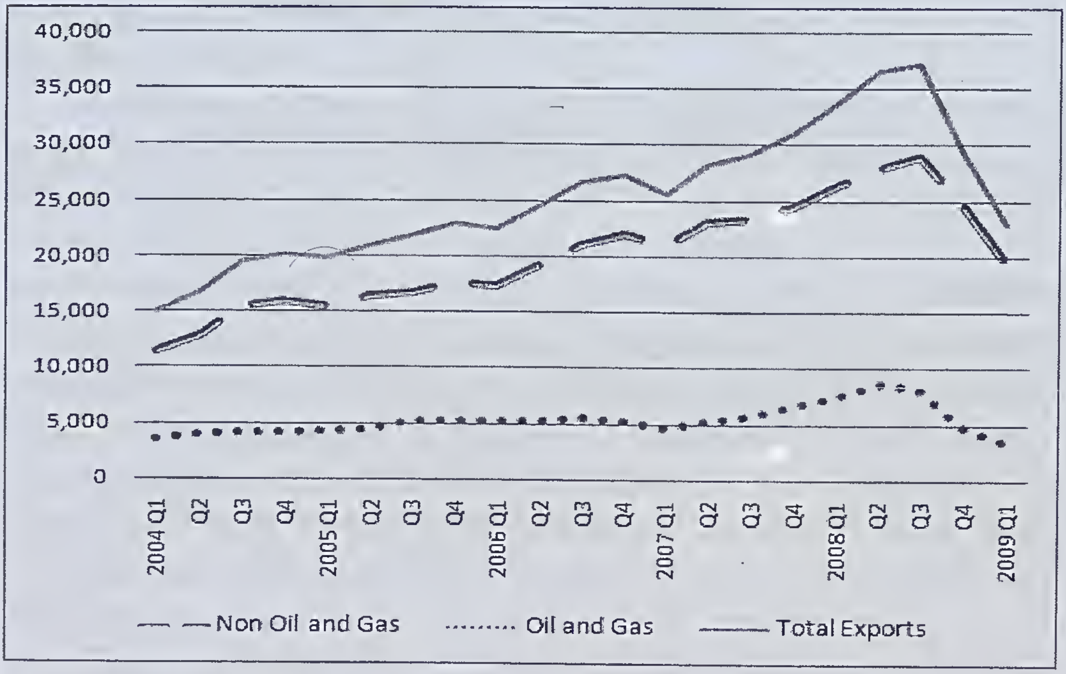
BALANCE OF PAYMENT

Merchandise exports plunged dramatically by growing negative 32.1% in Q1-2009, declining from US$33.7 billion in Q1-2008 to US$ 22.9 billion in Q1-2009. Meanwhile, merchandise imports also witnessed a dramatic contraction (-34.1%) with total import value around US$15.4 billion. As a result, the net export of merchandise in 2007 reached US$7.5 billion in Q1-2009. The current account surplus growth suffered contraction, as shown by a -27.8% growth.

Export and Import

By the Q1-2009, merchandise exports showed a very large contraction, which grew by -32.1% (y-o-y). The main driver of large contraction was oil and gas exports which declined by 55.1%. The declining in international oil price contributed to the downturn of exports. In other words, price effect is responsible for the decline. At the same time, non-oil and gas exports also experienced a downturn, growing at -27.5% in Q1-2009. While the value of oil and gas exports was around US$ 3.3 billion, non-oil and gas exports valued around US$19.5 billion.

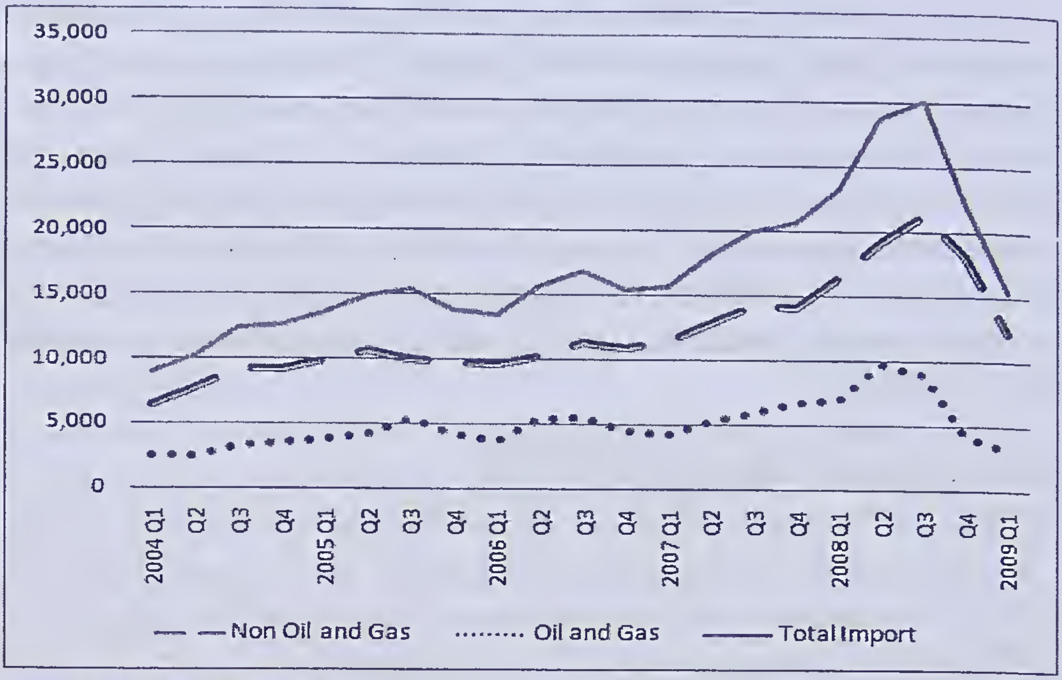
Figure 3. Export Value in USD million



Source: CEIC Asia Database

As exports plummeted, merchandise imports plunged even faster in Q1-2009. By the fourth quarter, merchandise imports decreased by 34.1%, which led to contraction in net exports. The decline in oil and gas imports was the main contributor behind the waning trend, which grew by -54.8% (y-o-y). Similar to exports, price effect influenced the downward trend of oil and gas imports. Furthermore, non-oil and gas imports also declined significantly by 25.3%. Overall, the total import value was around US$15.4 billion in Q4-2008.

Figure 4. Import Value in USD million



Source: CEIC Asia Database

Prospects

Obviously, no single country, including Indonesia, can be immune from the global recession. Moreover, the prospect of exports depends largely on the pace of economic recovery at the global level. At least two economies would influence Indonesia's external demand position, namely the US and Japan. Unless the recovery of these two economies takes place at rapid pace, external demand of Indonesia's merchandise will be slowing down. Nonetheless, non-oil and gas exports still continue to grow, albeit at slow pace. On this case, short remedies are mandatory since they may affect trade balance situation. First, the government should ease export credit obstacles. Second, duty and tax incentives should be applied on goods used as raw materials for exports. The latter is already addressed by the government whereas in regard to the former, the government needs to cooperate with other countries in the region.

OTHER ISSUES

Saving The Economy by Spending: The New Fiscal Stimulus Package

The government recently increased the figure of fiscal stimulus from IDR71.3 trillion to IDR73.3 trillion (US$ 6.66 billion). Yet there is no much different in new fiscal package compared to the former. The largest share of fiscal stimulus is still in the form of duty and tax incentives, including income tax, minimum tax threshold amounting to IDR56.3 trillion. Moreover, additional amount of IDR2 trillion will be used to fund 10 infrastructure projects worth IDR12.2 trillion. Of IDR12.2 trillion, IDR5.57 trillion will be allocated for public work projects, IDR2.24 trillion for transportation sectors and IDR1.27 trillion for energy projects.

In addition to these projects, public housing support is expected to secure the budget worth IDR 400 billion. Special agricultural and fisheries projects would receive IDR335 billion. Furthermore, to improve economic access, the government allocates IDR590 billion for marketplace infrastructure projects. To promote productivity among workers, the government sets vocational training centers development worth IDR300 billion. In addition, to help the vulnerable of economic shock and lagged areas, it allocates additional subsidy for generic drugs and medicines by IDR480 billion and Community Empowerment National Programme (*Program Nasional Pemberdayaan Masyarakat*/PNPM) by IDR500 billion. Table 5 summarises all components of the package.

Fiscal stimulus package through infrastructure project has been considered panacea for current global turmoil. As much as being so attractive proposal, one should expect that such package will not encounter rocks on the road. Yet expectation seems far from reality. Partisan approach by president SBY in delivering several programmes for the poor (e.g., PNPM or subsidy program) is his biggest failure in the last days of his presidency. Several subsidy programs aimed to protect the poor are now harshly monitored and even obstructed by the House of Representatives.

The parties in the House are worried that SBY would use fiscal stimulus as his political campaign. Though leery could be reasonable

considering the election in just coming two months, putting aside urgency and too much politicking in the time of crisis could place the country's economy at stake or even in catastrophe. Some observers still doubt that the president would get legislatives endorsement for his fiscal package. Yet the worst would come if the president will be much busier to get votes for the second seat of presidency, than lobbying the House for saving the economy.

Table 5. Fiscal Package in IDR trillion

Fiscal Package	Budget
Tax Rebate and Incentives	56.30
Diesel Fuel Subsidy	2.70
Discounted Electricity Rate	1.40
Infrastructure Projects	12.20
1. Public Works	5.57
2. Transportation	2.24
3. Energy	1.27
4. Public Housing	0.40
5. Agriculture and Fishery Projects	0.34
6. Marketplace Infrastructure	0.59
7. Vocational Training Centres	0.30
8. Subsidised Medicine	0.48
9. Community Empowerment National Program	0.50
10. Other Infrastructure Projects	0.51

Source: Ministry of Finance

Another important issue is the implementation of the stimulus package. Hoping all extents of the package would boost the economy is an ambitious agenda for Indonesia in particular. One, and perhaps the most important reason is the lack of credibility from past years' experience. As noted by many, large part of state budget for infrastructure spending had just failed to be realised, due to some issues in the governance of the infrastructure projects, high country risks, as well as unclear central-region arrangement regarding developing infrastructure in the country. Thus, in order to achieve an effective implementation of this year's infrastructure fund, the government has to firstly overcome many daunting tasks of all these

structural problems. However, the pressure to get the infrastructure projects really implemented could be a positive impact for indeed removing all these problems, and hence we could expect some portion of the projects should be really implemented this year.

The 2009 Election and The Economic Agenda

The 2009 Election was already held peacefully in spite of logistic failure of General Election Commision (KPU). Though the seats were still in count, the quick count of several polls ranked Democratic Party (PD), the president SBY's party, the first. A quick count conducted by Indonesia Survey Institute predicted that PD would gain 20.5% of the total popular votes. It is followed by the Indonesian Democratic Party of Struggle (PDI-P) and Golkar Party—the vice president's political party--getting 14.4% and 13.9% of the total popular votes respectively. Despite standing in the third position, some expect that Golkar may secure larger seats in parliament than PDIP, since the former's voters are distributed across regions while the latter's voters are concentrated in Java.

As such, there would be only three pairs of candidates running for the presidential election: SBY-Boediono, JK-Wiranto and Mega-Prabowo. Though a strong commitment on coalition is not discussed yet among political parties, it seems rather clear that the president SBY would mostly hold back current coalition.

Even though, there is less clear indication that SBY, the current president and the Chair of Board of Trusty of Democrat Party, will be re-elected, SBY seems to appoint current economic member team and continue the on-going development programs. Similar economic agenda would also not change much if the JK-Wiranto wins the election. This scenario may be different in the case of PDIP's-Gerindra coalition in taking the presidency. However, according to several polls, the popularity of SBY marks far higher than others, including Megawati Soekarnoputri, chairwoman of PDIP. Judging from the 2009 legislative election result, it is very likely that SBY would take his second-term of office.

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